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TRADE DEFICIT

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

MARCH 23, 1984

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CONTENTS

Administration Witnesses

	Page
Brock, Hon. William E., U.S. Trade Representative	26
Feldstein, Dr. Martin, Chairman, Council of Economic Advisers	45
McNamar, Hon. R.T., Deputy Secretary of the Treasury	87
Wallich, Henry C., Board of Governors, Federal Reserve System	76

Public Witnesses

Bergsten, C. Fred, director, Institute for International Economics	110
Roach, Stephen S., vice president and senior economist, Morgan Stanley & Co., Inc., New York, NY	135

Additional Information

Press release announcing hearing	1
Memorandum prepared by the International Trade Commission	2
Prepared statement:	
Senator Bob Dole	16
Senator Max Baucus	16
Senator Lloyd Bentsen	19
Senator George J. Mitchell	20
Hon. William E. Brock, U.S. Trade Representative	28
Dr. Feldstein, Chairman, Council of Economic Advisers	49
Henry C. Wallich, member, Board of Governors, Federal Reserve System	78
Hon. R.T. McNamar, Deputy Secretary of the Treasury	90
C. Fred Bergsten, director, Institute for International Economics	113
Stephen S. Roach, vice president and senior economist, Morgan Stanley & Co., Inc	138

Communications

Statement of Alfred Eches, Chairman, U.S. International Trade Commission	175
Statement, Consumers for World Trade	193

TRADE DEFICIT

FRIDAY, MARCH 23, 1984

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 10:22 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Danforth, Chafee, Heinz, Long, Bentsen, Baucus, Boren, and Mitchell.

Also present: Roderick DeArment, Esq., chief counsel and staff director.

The CHAIRMAN. I have a statement which I would like to include in the record.

[The press release announcing the hearing, a memorandum prepared by the International Trade Commission, and prepared statements of Senators Dole, Bentsen, Baucus, and Mitchell follow:]

[Press Release No. 84-123]

FINANCE COMMITTEE ANNOUNCES HEARING ON THE TRADE DEFICIT

Senator Robert J. Dole, Chairman of the Committee on Finance, announced today that a hearing will be held on Friday, March 23, 1984, on the growing trade deficit.

The hearing will begin at 10:00 a.m. in Room SD-215 of the Dirksen Senate Office Building.

In announcing the hearing, Senator Dole stated, "With the merchandise trade and current account deficits at their highest levels in U.S. history and expected to grow even larger, the Committee wants to have a clearer idea of the causes and consequences of this massive imbalance. The Administration appears divided on the causes of the trade deficit and how it might be reduced. This hearing should afford the Administration an opportunity to formulate the sort of analytical report envisioned by section 122 of the 1974 Trade Act. We also want to hear from witnesses who can shed light on the role of such factors as the relative competitiveness of our economy and of floating exchange rates.

"The Finance Committee has been devoting considerable effort toward reducing the Federal budget deficit, which is generally considered to be a major cause of the trade deficit. We want to explore further the correlation between the budget and trade deficits."

MEMORANDUM PREPARED BY THE INTERNATIONAL TRADE COMMISSION

Definition of Terms

The merchandise trade balance is the measure of exports and imports of goods. This balance is in deficit when imports of goods exceed exports of goods, and in surplus when exports exceed imports.

The current account balance is the measure of the flows in services income, earnings on investments, unilateral transfers (such as foreign aid and pension payments) and the merchandise trade. Thus the current account balance is a broader measure which incorporates the merchandise trade balance.

There are several ways of measuring the merchandise trade balance. Exports of goods normally are valued on an f.a.s. basis (free alongside ship). The comparable way of measuring imports is the customs valuation method, which is limited to the value of the goods, excluding the cost of insurance and freight on the goods. A more comprehensive measure is the c.i.f. method, which includes insurance and freight with the cost of the goods. A c.i.f. measure of imports will always result in a larger figure than the customs valuation method.

The Merchandise Trade Deficit

By any measure, the 1983 merchandise trade deficit was the largest in U.S. history. On an f.a.s./c.i.f. basis, the deficit was $69.4 billion. On an f.a.s./customs basis, the Bureau of Census calculates the deficit at $57.6 billion, and the Department of Commerce calculates the deficit for balance of payments purposes at $60.5 billion (this figure is also calculated on an f.a.s./customs basis, but includes unique items in Canadian/U.S. trade, such as overland transportation and payments for trans-border electrical consumption). This deficit was nearly twice the 1982 trade deficit of $36.4 billion, and is expected to exceed $100 billion in 1984. Figures (on a balance of payments basis) for the most recent three years are as follows:

U.S. Merchandise Trade
(f.a.s./cus; millions of dollars)

	1981	1982	1983
Exports	237,019	211,217	200,203
Imports	265,086	247,606	260,753
Balance	-28,067	-36,389	-60,550

Detailed figures on the U.S. balance of payments are contained in the table and charts contained in the appendix.

Virtually all of the 1983 deterioration in the U.S. trade position was accounted for by the decline in manufactured goods, as the deficit in this category widened to $31 billion from a deficit of $4.3 billion in 1982.

The following table indicates the shift between 1982 and 1983 by product areas:

U.S. Merchandise Trade - Selected Product Areas
($ billion; f.a.s.; seasonally adjusted)*

Cumulative: January to December

	1983	1982	Percent Change 1983/1982
Imports:			
Total	258.0	244.0	+6
Petroleum	52.3	60.5	-14
Nonpetroleum	205.7	183.5	+12
of which, manufactures	163.4	144.0	+13
Exports:			
Total	200.5	212.2	-6
Agriculture	36.5	37.0	-1
Manufactures	132.4	139.7	-5
Other (e.g., crude materials)	31.6	35.5	-11

* Based on Bureau of Census figures

On a bilateral basis, the largest shift in the trade balance was registered with respect to Latin America. Financial problems have obligated most Latin American countries to slash their imports far below the levels of 1981 when credit was still plentiful. Along with European and Japanese exporters, the United States has seen its sales to Latin America tumble 40 percent and more. In absolute terms, the U.S. incurred its largest trade deficits with Japan (approximately $20 billion), Canada (approximately $14 billion) and Mexico (approximately $8 billion).

The following table sets out U.S. bilateral and regional trade balances since 1981:

U.S. Regional Merchandise Trade and Balances
($ billion; f.a.s./cus; seasonally adjusted)

	1983 Cumulative: Jan.-Dec.		Trade Balance		
	Exp.	Imp.	1983 (actual)	1982 (actual)	1981 (actual)
World*	200.5	258.0	-57.6	-31.8	-27.6
DCs	122.8	152.2	-29.4	-19.1	-5.7
W.Europe	56.0	53.9	+2.1	+8.8	+13.5
EC	44.3	43.9	+0.4	+5.4	+10.8
Japan	21.9	41.2	-19.3	-16.7	-15.8
Canada	38.2	52.1	-13.9	-12.8	-6.8
Australia	4.0	2.2	+1.8	+2.2	+2.7
LDCs	72.3	102.3	-30.0	-16.3	-27.3
OPEC	16.9	25.1	-8.2	-8.3	-27.9
Non-OPEC	55.4	77.2	-21.8	-8.0	+0.5
Latin America	22.6	35.7	-13.1	-5.0	+3.1
Brazil	2.6	4.9	-2.3	-0.9	-0.7
Mexico	9.1	16.8	-7.7	-3.8	+4.0
Venezuela	2.8	4.9	-2.1	+0.4	-0.2
Near East & North Africa	18.0	11.1	+6.9	+5.0	N.A.***
Saudi Arabia	7.9	3.6	+4.3	+1.6	-7.1
Israel	2.0	1.3	+0.7	+1.1	+1.3
Egypt	7.8	0.3	+2.5	+2.4	+1.8

(Table continued from previous page)

U.S. Regional Merchandise Trade and Balance
($ billion; f.a.s./cus; seasonally adjusted)

	1982 Cumulative: Jan.-Dec.		Trade Balance		
	Exp.	Imp.	1983 (actual)	1982 (actual)	1981 (actual)
South and East Asia	25.9	40.9	-15.0	-8.3	-10.6
Hong Kong	2.6	6.4	-3.8	-3.0	-2.8
Korea	5.9	7.1	-1.2	-0.1	0.0
Taiwan	4.7	11.2	-6.5	-4.5	-3.7
ASEAN**	9.9	13.3	-3.4	-1.3	-4.4
Africa (sub-Sahara)	4.5	10.5	-6.0	-8.3	N.A.***
South Africa	2.1	2.1	+0.0	+0.4	+0.7
Nigeria	0.9	3.7	-2.8	-5.7	-7.7
Communist Countries	5.1	3.6	+1.5	+3.2	+4.4
USSR	2.0	0.3	+1.7	+2.4	+2.1
E.Europe	0.9	1.1	-0.2	+0.2	+0.7
P.R.C.	2.2	2.2	0.0	+0.6	+1.7

* World totals exclude military grant aid exports and are seasonally adjusted; area and country totals include military grant aid exports and are not seasonally adjusted.

** Includes Singapore, Thailand, Indonesia, Malaysia and the Phillipines

*** Totals not available due to changes in definitional basis.

The Current Account Balance

In recent years, large merchandise trade deficits have been compensated for by substantial surpluses in the U.S. balance for investment income and services trade. At the end of 1983, the United States had an estimated international net creditor position of about $125 billion. This position as an international creditor has provided major support for the U.S. balance of payments. The United States had a surplus of investment income averaging more than $30 billion annually during 1979-1981. This has permitted the United States to tolerate significant trade deficits without incurring a deficit in the current account. As the United States borrows funds from abroad to finance its Federal budget deficits and the United States moves toward the position of a net debtor country, this advantage will be eroded. By 1983, the surplus on investment income had fallen below $25 billion.

The following chart indicates what a large role investment income surpluses have played in containing the size of the current account deficits:

U.S. Current Account Since 1976
Major Components
($ million; BOP; seasonally adjusted)

	Merchandise Trade Balance	Total Net Investment Income	Foreign Direct Investment Income	Other Services Trade Balance	Other*	Current Account Balance
1976	-9,483	15,975	15,889	2,153	-4,439	+4,207
1977	-31,091	17,962	16,839	1,707	-3,089	-14,511
1978	-33,966	20,565	21,247	2,440	-4,485	-15,446
1979	-27,555	31,218	31,973	2,800	-7,427	-964
1980	-24,554	29,570	27,680	5,738	-9,342	+421
1981	-28,067	33,483	24,065	7,462	-8,286	+4,592
1982	-36,389	27,304	18,055	5,727	-7,855	-11,211
1983	-60,596	23,581	15,004	4,790	N.A.	-40.776

* Includes U.S. military agency sales, direct defense expenditures, and unilateral transfers such as foreign aid, U.S. Government pensions and other official and private transfers and remittances.

The relative size of the U.S. current account deficit is illustrated by the following table:

Current Account Balance:*
Selected Countries
($ billion; BOP)

	U.S.**	France	F.R. Germany	United Kingdom	Japan	Canada
Yearly						
1976	+4.2	-5.9	+ 3.9	-1.6	+3.7	-3.9
1977	-14.5	-3.0	+ 4.1	-0.1	+10.9	-4.0
1978	-15.5	+3.8	+9.0	+1.8	+16.5	-4.3
1979	+1.0	+1.2	-6.2	-3.7	-8.8	-4.2
1980	+0.4	-7.8	-16.5	+7.4	-10.7	-1.7
1981	+4.6	-5.5	-6.8	NA	+4.8	-4.4
1982	-11.2	-12.1	+3.4	+9.3	+6.9	+2.4
1983	-40.8	-4.7***	+3.3	+2.9	+21.0	+0.9***

* Converted to dollars at current market rates of exchange.
** U.S. data is seasonally adjusted.
***Figures are for the first three quarters of 1983.

On a country-by-country basis, the largest shift in the U.S. current account balance has occurred in Latin America, where the U.S. current account has deteriorated by $15 billion in one year. In absolute terms, the U.S. current account deficit with Japan has been and continues to be the largest, at over $18 billion in 1983.

U.S. Bilateral Current Account Balances
($ million; BOP)

	1982	1983
Western Europe	2,370	-6,036
EC	1,794	-5,459
Eastern Europe	3,027	-1,749
Canada	-18	691
Latin America and other Western Hemisphere	7,615	-8,287
Japan	-15,768	-18,309
Australia, New Zealand and South Africa	4,167	2,929
Other Asia and Africa	-12,058	-13,627

Section 122 of the 1974 Trade Act

Section 122 of the Trade Act of 1974 authorizes the President to take action for any one of the following three reasons. First, to deal with large and serious U.S. balance-of-payments deficits. Second, to prevent an imminent and significant depreciation of the dollar in foreign exchange markets. Third, to cooperate with other countries in correcting an international balance of payments disequilibrium. In responding to any of the above situations, the President has three options: first, to impose a temporary import surcharge, not to exceed 15 percent ad valoreum. This charge would be in addition to already existing tariffs imposed on imported products; second, to impose a temporary quota on imported goods; and third, to impose a combination quota and surcharge. While quotas are permitted under the statute, they are clearly to be used only "to the extent that the fundamental imbalance (of payments) cannot be dealt with effectively by a surcharge..."

Although the statute requires the President to impose a surcharge,quota or surcharge/quota "whenever" fundamental international payments problems require special import measures to restrict imports, the President need not take such actions if it would be contrary to the national interest. However, in this event the President must immediately inform Congress of his determinations, and convene a group of congressional advisers and consult with them as to the reasons for finding that an import surcharge is not in the national interest.

In the most recent use of an import surcharge, President Nixon issued Proclamation 4047 on August 15, 1971, which imposed a ten percent ad valorem surcharge on a large volume of imports. This action was taken as a means of counteracting (1) an exceptionally severe and worsening balance of payments deficit, (2) a U.S. gold reserve that had dropped from $17.8 billion in 1960 to less than $10.4 billion in June 1971, and (3) foreign exchange rates which were believed to be creating an overvalued dollar. The principal purpose and effect of the 1971 surcharge was to end the system of fixed exchange rates in which the dollar was said to be overvalued, and the surcharge was revoked upon the signing of the Smithsonian Agreement on floating exchange rates.

Although the President's authority to impose the import surcharge was declared invalid by the U.S.Customs Court, the President's action was upheld on appeal in United States v. Yoshida, 526 F.2d 560 (1975) based on the emergency authority of section 5(b) of the Trading with the Enemy Act. Section 122 of the Trade Act was enacted in part to insure that the President would have this authority, since at the time the provision was under consideration in Congress, the Yoshida case had not yet been successfully appealed.

APPENDIX

U.S. INTERNATIONAL TRANSACTIONS

	CREDITS (+), DEBITS (-)	1983'
37	U S ASSETS ABR NET (INC/CAP OUTFL-)	-49,297
38	U S OFFICIAL RESERVE ASSETS NET	-1,196
39	GOLD	---
40	SPECIAL DRAWING RIGHTS	-68
41	RESERVE POSITION IN IMF	-4,434
42	FOREIGN CURRENCIES	3,304
43	U S GOVT ASSETS OTH THAN OFF RES	-4,897
44	U S LOANS & OTH L-T ASSETS	-10,197
45	REPAYMENTS ON U S LOANS	5,226
46	US FORGN CUR HLD & S-T ASSETS	74
47	U S PRIVATE ASSETS NET	-43,206
48	DIRECT INVESTMENTS ABROAD	-7,608
49	EQUITY & INTERCOMPANY ACCTS	1,848
50	REINV EARNINGS OF INC AFF	-9,456
51	FOREIGN SECURITIES	-7,484
	U S CLAIMS UNAF FORGN NONBANKS	
52	LONG-TERM	-3,146
53	SHORT-TERM	
	U S CLAIMS RPT BY BANKS, NIE	
54	LONG-TERM	-24,966
55	SHORT-TERM	
56	FORGN ASSETS US NET (INC/CAP INF+)	83,019
57	FORGN OFF ASSETS IN U S, NET	5,083
58	U S GOVERNMENT SECURITIES	6,676
59	U S TREASURY SECURITIES	7,140
60	OTHER	-464
61	OTHER U S GOVT LIABILITIES	318
62	U S LIAB RPT BY BANKS, NIE	877
63	OTHER FORGN OFFICIAL ASSETS	-1,788
64	OTHER FORGN ASSETS IN U S NET	76,935
65	DIRECT INVESTMENTS IN U S	9,514
66	EQUITY & INTERCOMPANY ACCTS	7,800
67	REINV EARNINGS OF INC AFF	1,714
68	U S TREASURY SECURITIES	8,599
69	US SECURITIES OTH THAN TREAS	8,587
	U S LIAB UNAF FORGN NONBANKS	
70	LONG-TERM	-1,060
71	SHORT-TERM	
	U S LIAB RPT BY BANKS, NIE	
72	LONG-TERM	51,295
73	SHORT-TERM	
74	ALLOCATIONS OF SPECIAL DRAW RIGHTS	---
75	STATISTICAL DISCREPANCY (SUM ABV)	7,055
	MEMORANDA:	
76	BALANCE ON MERCHANDISE TRADE	-60,530
77	BALANCE ON GOODS AND SERVICES	-32,177
78	BAL ON GOODS SVCS & REMITTANCES	-34,809
79	BALANCE ON CURRENT ACCOUNT	-40,776
	TRANS U S ORA & FOR OFF ASTS IN U S	
80	INCREASE (-) U S ORA, NET	-1,196
81	INC (+) FORGN OFF ASTS IN U S	5,765

U.S. INTERNATIONAL TRANSACTIONS

	CREDITS (+), DEBITS (-)	1983[P]
1	EXPORTS OF GOODS & SERVICES	334,233
2	MERCH ADJUSTED EXCLU MILIT	200,203
3	TRANS JNO MILIT SALES CONTR	12,657
4	TRAVEL	11,187
5	PASSENGER FARES	5,153
6	OTHER TRANSPORTATION	13,479
7	FEES ROYAL FROM AFFIL FORGN	5,975
8	FEES ROYAL FROM UNAFL FORGN	1,686
9	OTHER PRIVATE SERVICES	7,282
10	U S GOV MISC SERVICES	574
	RECEIPTS OF INC U S ASSETS ABR	
11	DIRECT INVESTMENTS	22,165
12	INT, DIV & EARN UNINC AFF	12,710
13	REINV EARNINGS OF INC AFF	9,456
14	OTHER PRIVATE RECEIPTS	50,948
15	U S GOVERNMENT RECEIPTS	4,922
16	TRANS GDS & SVCS UNO MIL GRT	209
17	IMPORTS OF GOODS & SERVICES	-356,410
18	MERCH ADJUSTED EXCLU MILIT	-260,753
19	DIRECT DEFENSE EXPENDITURES	-12,174
20	TRAVEL	-13,944
21	PASSENGER FARES	-5,636
22	OTHER TRANSPORTATION	-12,482
23	FEES ROYAL TO AFFIL FOREIGN	-245
24	FEES ROYAL TO UNAFL FOREIGN	-308
25	PRIVATE PMTS FOR OTHER SVCS	-4,176
26	U S GOV PMTS FOR MISC SVCS	-2,235
	PAYMTS OF INC FORGN ASSETS U S	
27	DIRECT INVESTMENTS	-7,161
28	INT, DIV & EARN UNINC AFF	-5,447
29	REINV EARNINGS OF INC AFF	-1,716
30	OTHER PRIVATE PAYMENTS	-29,579
31	U S GOVERNMENT PAYMENTS	-17,714
32	MIL GRTS OF GDS & SVCS NET	-209
33	UNIL TRANS EXCL MIL GRTS NET	-8,599
34	U S GOV GRANTS EXCLU MILIT	-5,967
35	U S GOV PENSIONS AND TRANS	-1,577
36	PRIVATE REMITS & OTH TRANS	-1,055

U.S. International Transactions

Millions of 3

Line	(Credits +, debits −)[1]	1960	1961	1962	1963	1964	1965	1966	1967	1968
1	Exports of goods and services [2]	26,861	29,037	31,850	34,214	36,836	41,967	44,542	47,314	52,365
2	Merchandise, adjusted, excluding military [2]	19,650	20,100	20,781	22,272	25,501	26,461	29,310	30,666	33,626
3	Transfers under U.S. military agency sales contracts	335	402	646	657	747	830	939	1,152	1,392
4	Travel	919	947	937	1,013	1,207	1,295	1,389	1,646	1,772
5	Passenger fares	173	183	191	206	241	271	317	371	411
6	Other transportation	1,607	1,636	1,764	1,986	2,078	2,175	2,339	2,439	2,547
7	Fees and royalties from affiliated foreigners	880	942	980	1,030	1,015	1,199	1,162	1,254	1,430
8	Fees and royalties from unaffiliated foreigners	247	264	296	273	301	285	308	302	427
9	Other private services	570	607	563	613	651	714	814	951	1,024
10	U.S. Government miscellaneous services	153	164	195	236	265	285	305	326	333
	Receipts of income on U.S. assets abroad:									
11	Direct investments	3,621	3,823	4,241	4,636	5,105	5,506	5,989	6,068	6,701
12	Interest, dividends, and earnings of unincorporated affiliates	2,555	2,703	2,944	3,179	3,674	3,923	3,967	3,947	4,153
13	Reinvested earnings of incorporated affiliates	1,066	1,120	1,297	1,457	1,432	1,583	1,793	1,756	2,448
14	Other private receipts	646	703	804	1,022	1,256	1,427	1,689	1,781	2,021
15	U.S. Government receipts	349	382	472	499	462	510	589	628	736
16	Transfers of goods and services under U.S. military grant programs, net	1,686	1,665	1,527	1,542	1,340	1,636	1,880	2,039	2,547
17	Imports of goods and services	−23,739	−25,501	−25,779	−27,847	−29,225	−32,491	−36,369	−41,686	−45,886
18	Merchandise, adjusted, excluding military [2]	−14,758	−14,537	−16,260	−17,048	−18,700	−21,510	−25,493	−26,866	−32,991
19	Direct defense expenditures	−2,987	−2,906	−3,105	−2,961	−2,940	−2,952	−3,764	−4,378	−4,532
20	Travel	−1,710	−1,781	−1,929	−2,114	−2,211	−2,438	−2,627	−3,207	−3,501
21	Passenger fares	−513	−546	−567	−612	−642	−717	−758	−829	−885
22	Other transportation	−1,602	−1,637	−1,658	−1,701	−1,817	−1,951	−2,161	−2,137	−2,367
23	Fees and royalties to affiliated foreigners	−36	−43	−57	−61	−67	−68	−84	−82	−90
24	Fees and royalties to unaffiliated foreigners	−69	−68	−64	−51	−69	−67	−76	−104	−106
25	Private payments for other services	−503	−548	−529	−695	−527	−681	−806	−845	−869
26	U.S. Government payments for miscellaneous services	−313	−406	−389	−447	−525	−559	−644	−691	−760
	Payments of income on foreign assets in the United States:									
27	Direct investment	−304	−422	−380	−430	−529	−627	−711	−821	−876
28	Interest, dividends, and earnings of unincorporated affiliates	−220	−194	−165	−222	−302	−290	−372	−361	−388
29	Reinvested earnings of incorporated affiliates	−174	−228	−214	−208	−227	−336	−339	−460	−488
30	Other private payments	−511	−535	−546	−701	−802	−942	−1,221	−1,328	−1,868
31	U.S. Government payments	−322	−278	−229	−401	−458	−469	−549	−594	−702
32	U.S. military grants of goods and services, net	−1,686	−1,665	−1,527	−1,542	−1,340	−1,636	−1,882	−2,039	−2,547
33	Unilateral transfers (excluding military grants of goods and services), net	−2,908	−3,324	−2,630	−2,784	−2,781	−2,654	−2,932	−3,125	−3,952
34	U.S. Government grants (excluding military grants of goods and services)	−1,672	−1,852	−1,918	−1,917	−1,909	−1,906	−1,910	−1,895	−1,798
35	U.S. Government pensions and other transfers	−214	−253	−245	−252	−279	−289	−367	−441	−457
36	Private remittances and other transfers	−433	−434	−477	−615	−614	−477	−656	−879	−696
37	U.S. assets abroad, net (increase/capital outflow (−))	−6,999	−5,538	−8,174	−7,270	−9,860	−5,716	−7,221	−9,787	−10,977
38	U.S. official reserve assets, net [3]	2,145	607	1,535	278	171	1,225	370	53	−870
39	Gold	1,702	857	980	461	125	1,065	571	1,170	1,173
40	Special drawing rights									
41	Reserve position in the International Monetary Fund	422	−135	439	29	286	−94	337	−94	−870
42	Foreign currencies		−115	19	−112	−239	−306	−538	−1,023	−1,173
43	U.S. Government assets, other than official reserve assets, net	−1,100	−910	−1,081	−1,082	−1,080	−1,005	−1,543	−2,423	−2,274
44	U.S. loans and other long-term assets	−1,214	−1,078	−1,128	−2,264	−2,302	−2,463	−2,513	−3,638	−3,722
45	Repayments on U.S. loans [4]	843	1,279	1,294	986	729	874	1,230	1,005	1,295
46	U.S. foreign currency holdings and U.S. short-term assets, net	−729	−381	−245	−467	−19	−16	−260	210	52
47	U.S. private assets, net	−5,144	−5,235	−6,622	−5,906	−6,950	−5,936	−6,047	−7,396	−7,933
48	Direct investment	−2,940	−2,653	−2,851	−3,402	−3,760	−5,011	−5,418	−4,805	−5,285
49	Equity and intercompany accounts	−1,974	−1,589	−1,654	−1,976	−2,328	−3,468	−3,625	−3,049	−2,855
50	Reinvested earnings of incorporated affiliates	−1,066	−1,064	−1,197	−1,507	−1,432	−1,543	−1,793	−1,756	−2,448
51	Foreign securities	−663	−702	−960	−1,105	−677	−739	−729	−1,309	−1,569
	U.S. claims on unaffiliated foreigners reported by U.S. nonbanking concerns:									
52	Long-term	−69	−127	−132	162	−695	−95	−112	−281	−230
53	Short-term	−304	−43 [5]	−222	−5	−623	429	−239	−496	−962
	U.S. claims reported by U.S. banks, not included elsewhere:									
54	Long-term	−152	−186	−136	−775	−981	−232	217	235	239
55	Short-term	−986	−1,135	−324	−781	−1,524	325	−84	−730	−105
56	Foreign assets in the United States, net (increase/capital inflow (+))	2,284	2,705	1,911	2,217	2,643	742	2,861	7,379	9,930
57	Foreign official assets in the United States, net	1,473	765	1,270	1,946	1,020	134	−972	2,441	−774
58	U.S. Government securities	655	253	1,459	814	422	−141	−1,527	2,261	−789
59	U.S. Treasury securities [6]	655	228	1,410	980	434	−154	−1,548	2,222	−788
60	Other [7]			−1	12	−7	−7	21	39	29
61	Other U.S. Government liabilities [8]	215	25	132	428	280	68	113	63	−15
62	U.S. liabilities reported by U.S. banks, not included elsewhere	603	569	−291	742	909	219	742	1,166	10
63	Other foreign official assets [9]									
64	Other foreign assets in the United States, net	811	1,939	641	1,231	1,992	607	4,333	2,938	10,709
65	Direct investments	315	317	346	231	322	415	425	686	807
66	Equity and intercompany accounts	141	78	132	−5	−5	57	86	258	319
67	Reinvested earnings of incorporated affiliates	174	238	214	236	327	358	339	428	488
68	U.S. Treasury securities	−364	151	−68	−149	−105	−121	−336	−135	136
69	U.S. securities other than U.S. Treasury securities	282	224	134	297	−85	−366	906	1,016	4,414
	U.S. liabilities to unaffiliated foreigners reported by U.S. nonbanking concerns:									
70	Long-term	1	50	3	−13	−38	29	169	65	715
71	Short-term	−91	176	−112	−23	113	149	394	490	750
	U.S. liabilities reported by U.S. banks, not included elsewhere:									
72	Long-term [10]	6	−5	5	53	98	341	188	150	72
73	Short-term [10]	672	953	331	845	1,730	262	2,804	1,607	3,790
74	Allocations of special drawing rights									
75	Statistical discrepancy (sum of above items with sign reversed)	−1,019	−969	−1,124	−260	−997	−458	639	−356	436
	Memoranda:									
76	Balance on merchandise trade (lines 2 and 18)	4,892	5,571	4,521	5,224	6,801	4,951	3,817	3,800	635
77	Balance on goods and services (lines 1 and 17) [11]	5,122	6,346	6,025	7,167	9,604	9,285	5,963	5,708	3,563
78	Balance on goods, services, and remittances (lines 77, 35, and 36)	4,496	5,677	5,303	6,331	8,711	7,239	4,941	4,386	2,220
79	Balance on current account (lines 77 and 31) [11]	2,824	3,622	2,907	4,414	6,883	5,452	3,031	2,583	611
	Transactions in U.S. official reserve assets and in foreign official assets in the United States:									
80	Increase (−) in U.S. official reserve assets, net (line 38)	2,145	607	1,535	278	171	1,225	370	53	−870
81	Increase (+) in foreign official assets in the United States (line 57 less line 61)	1,258	741	1,138	1,518	1,362	68	−785	2,380	−758

See footnotes on page 37.

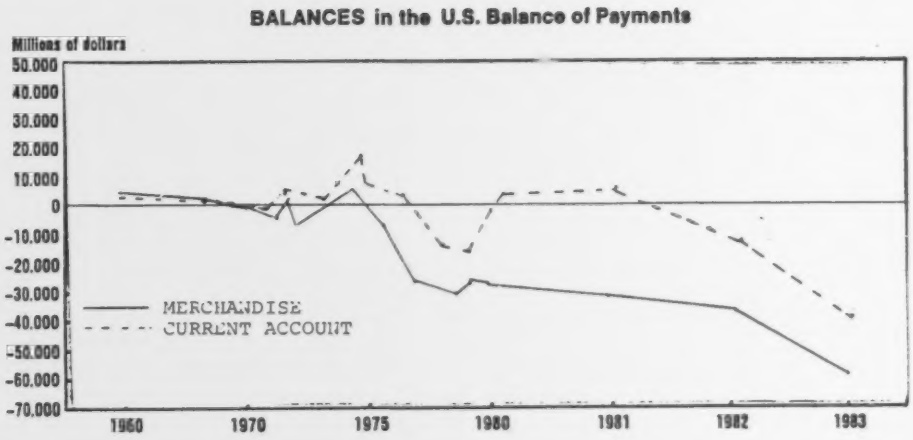
Transactions

dollars]

1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	Line
57,622	65,674	66,826	77,496	110,241	146,606	155,729	171,620	184,776	219,994	286,796	343,673	374,621	348,224	1
36,414	42,469	43,319	49,381	71,419	98,306	107,888	114,745	128,816	142,054	184,473	224,237	237,019	211,217	2
1,838	1,901	1,928	1,964	2,569	3,379	4,049	5,454	7,351	7,973	6,316	8,181	9,727	12,697	3
2,043	2,321	2,534	2,817	3,412	4,022	4,697	5,742	6,150	7,189	8,441	10,131	12,163	11,286	4
459	544	615	696	973	1,104	1,038	1,229	1,366	1,663	2,164	2,662	2,891	2,979	5
2,662	3,135	3,290	3,579	4,665	5,697	5,940	6,747	7,660	8,136	9,971	11,647	12,882	12,427	6
1,338	1,768	1,827	2,115	2,513	3,070	3,343	3,531	3,863	4,705	4,986	5,709	5,813	5,572	7
686	879	918	955	712	751	757	822	1,007	1,180	1,294	1,362	1,480	1,547	8
1,140	1,294	1,446	1,764	1,965	2,221	2,299	2,444	2,848	4,256	4,495	5,480	6,197	6,376	9
343	382	347	357	401	419	446	489	547	630	688	862	435	640	10
7,849	8,109	9,190	10,349	16,542	19,157	16,695	18,999	19,072	25,456	38,193	37,146	32,446	22,886	11
4,819	4,986	5,982	6,416	8,994	11,279	8,547	11,363	12,277	14,115	19,219	20,139	18,962	17,545	12
2,830	3,177	3,177	4,532	8,158	7,777	8,048	7,986	6,396	11,343	18,963	17,017	13,483	5,323	13
2,988	3,671	3,841	3,949	4,309	7,356	7,644	8,958	10,881	14,944	23,454	22,737	20,113	17,127	14
925	997	994	986	936	1,074	1,112	1,332	1,625	1,943	2,286	2,462	2,694	4,131	15
2,819	2,713	3,548	4,492	2,919	1,818	2,397	273	989	235	668	736	690	644	16
-34,139	-38,056	-39,649	-79,435	-99,219	-127,819	-122,949	-162,625	-194,178	-230,335	-282,110	-334,566	-363,896	-251,562	17
-35,807	-39,824	-43,179	-84,797	-79,470	-100,911	-90,152	-124,229	-151,907	-176,029	-212,924	-249,781	-265,094	-247,806	18
-4,806	-4,855	-4,819	[10]-4,784	[10]-4,629	-5,032	-4,796	-4,895	-5,823	-7,552	-8,264	-10,467	-11,902	-11,318	19
-3,272	-3,980	-4,272	-5,042	-5,526	-5,940	-6,417	-6,836	-7,451	-9,475	-9,413	-10,397	-11,479	-12,994	20
-1,980	-1,218	-1,290	-1,506	-1,790	-2,095	-2,263	-2,565	-2,748	-2,986	-3,144	-3,697	-4,487	-4,772	21
-2,455	-2,643	-3,130	-3,539	-4,094	-5,942	-5,698	-6,852	-7,972	-9,124	[10]-10,296	-11,790	-12,279	-11,638	22
-101	-111	-118	-156	-399	-160	-397	-393	-343	-380	-523	-514	-412	-42	23
-129	-114	-123	-139	-176	-160	-198	-189	-952	-977	-380	-363	-296	-261	24
-751	-827	-966	-1,043	-1,189	-1,262	-1,581	-2,006	-2,190	-2,573	-2,822	-3,084	-3,152	-3,700	25
-717	-725	-765	-788	-862	-967	-1,044	-1,227	-1,268	-1,545	-1,718	-1,749	-1,822	-2,236	26
-843	-975	-1,104	-1,284	-1,610	-1,331	-2,234	-3,110	-2,834	-4,211	-6,357	-9,479	-7,454	-4,844	27
-417	-441	-621	-715	-699	-266	-1,046	-1,451	-1,248	-1,628	-2,402	-3,308	-2,624	-5,008	28
-431	-534	-542	-569	-910	-1,065	-1,189	-1,659	-1,586	-2,583	-3,955	-6,167	-3,761	-164	29
-3,244	-3,617	-3,435	-2,984	-4,392	-6,491	-5,780	-5,681	-6,541	-8,795	-13,481	-20,893	-29,563	-23,749	30
-777	-1,024	-1,844	-2,684	-3,836	-4,362	-4,542	-4,529	-5,542	-8,674	-11,976	-12,512	-16,758	-18,259	31
-2,819	-2,713	-3,546	-4,492	-2,919	-1,818	-2,397	-273	-989	-235	-668	-736	-690	-644	32
-2,994	-3,254	-3,701	-3,854	-3,681	[10]-7,146	-4,613	-4,996	-4,617	-5,196	-5,849	-7,866	-6,831	-8,654	33
-1,849	-1,736	-2,043	-2,173	-1,936	[10]-3,475	-2,494	-3,146	-2,787	-3,176	-3,560	-4,700	-4,549	-5,413	34
-606	-662	-542	-272	-592	-894	-813	-994	-971	-1,886	-1,989	-1,262	-1,464	-1,493	35
-969	-1,098	-1,117	-1,109	-1,250	-1,017	-906	-917	-859	-944	-930	-1,044	-918	-1,128	36
-11,588	-9,237	-12,475	-14,497	-23,674	-34,745	-39,782	-31,398	-34,788	-61,138	-64,231	-86,662	-110,681	-118,045	37
-1,179	2,681	2,349	-6	158	-1,467	-949	-2,568	-375	722	-1,133	-8,155	-5,175	-4,965	38
-967	797	966	547					-118	-65	-65		(*)		39
	-861	-949	-708	0	-172	-86	-79	-121	1,249	-1,136	-16	-1,824	-1,271	40
-1,024	389	1,350	153	-33	-1,265	-695	-2,212	-394	4,231	-189	-1,967	-2,681	-5,552	41
622	2,156	362	-1	182	-30	-317	-288	158	-4,683	257	-6,472	-861	-1,841	42
-2,200	-1,549	-1,884	-1,569	-2,644	[10]-344	-2,474	-4,214	-3,680	-4,680	-3,706	-5,140	-5,078	-5,722	43
-3,489	-3,280	-4,181	-3,819	-4,539	-3,001	-5,941	-6,943	-6,445	-7,470	-7,897	-9,897	-9,717	-10,117	44
1,289	1,731	2,115	2,966	2,526	[10]-4,258	2,675	2,585	2,719	2,941	3,976	4,488	4,419	4,394	45
89	-16	182	165	-602	[10]-541	-9	123	33	-131	25	269	220	51	46
-9,296	-10,229	-12,940	-12,955	-20,306	-33,643	-35,389	-44,498	-30,717	-57,200	-59,433	-72,737	-100,348	-107,248	47
-5,960	-7,240	-7,618	-7,747	-11,358	-9,052	-14,244	-11,949	-11,899	-16,056	-25,222	-19,222	-5,690	3,668	48
-3,130	-4,413	-4,441	-5,214	-8,195	-1,275	-6,196	-4,253	-5,694	-4,715	-6,258	-2,205	3,663	8,231	49
-2,830	-3,177	-3,177	-4,532	-8,158	-7,777	-8,048	-7,986	-6,396	-11,343	-18,963	-17,017	-13,483	-5,323	50
-1,549	-1,976	-1,113	-518	-671	-1,854	-6,247	-6,860	-5,499	-8,636	-4,726	-3,554	-5,530	-7,896	51
-434	-686	-168	-249	-326	-474	-266	-43	-99	-53	[10]-3,291	[10]-3,174	[10]-1,181	[10]6,978	52
286	-10	-1,081	-811	-1,907	-2,747	-991	-2,254	-1,941	-2,800					53
297	155	-612	-1,307	-903	-1,183	-2,257	-2,302	-781						54
-987	-1,122	-2,360	-2,199	-3,947	-10,253	-11,175	-19,686	-10,976	[10]-23,867	[10]-26,213	[10]-46,898	[10]-39,851	[10]-109,345	55
12,782	6,360	12,979	21,461	16,586	34,341	15,679	26,518	44,319	64,696	86,732	84,922	98,573	87,866	56
-1,301	6,988	26,879	10,475	6,035	10,546	7,027	17,693	26,516	33,679	-13,665	15,666	5,430	3,172	57
-2,343	9,430	26,379	8,470	441	4,172	5,563	9,986	22,588	24,221	-21,972	11,895	6,272	8,099	58
-2,289	9,411	26,576	8,213	50	3,279	4,695	9,319	20,220	23,555	-22,435	9,708	4,989	3,740	59
-74	28	-8	257	362	902	868	573	2,368	666	463	2,187	1,289	-670	60
231	-446	-510	182	906	801	1,517	4,627	1,400	2,476	-46	685	-78	504	61
782	-2,078	819	1,530	4,126	5,818	-2,148	980	773	5,551	7,213	-169	-2,479	-2,954	62
			185	303	354	2,104	2,305	2,105	1,430	1,135	3,146	2,883	-367	63
14,082	-160	-2,988	10,986	12,382	23,696	8,642	18,825	14,588	30,256	52,418	39,256	75,243	64,894	64
1,263	1,684	367	949	2,800	4,780	2,082	4,347	3,738	7,397	11,277	15,884	21,292	10,390	65
532	1,020	-175	240	1,890	2,686	1,414	2,687	2,142	5,313	7,221	7,660	14,230	10,564	66
431	434	542	569	910	1,065	1,189	1,639	1,596	2,083	2,965	6,167	3,761	-164	67
-68	51	-29	-30	-216	697	2,690	2,702	534	[10]2,178	[10]4,969	[10]2,842	[10]-7,694	43	68
2,130	2,189	2,589	4,567	4,041	278	2,565	1,384	2,437	2,234	1,231	5,457	7,371	6,141	69
701	1,112	384	894	296	-90	495	-1,080	-847	-190					70
91	982	-15	221	727	1,584	-97	422	1,433	2,079	[10]1,021	[10]-3,945	[10]942	[10]-3,104	71
109	23	-250	149	227	9	-250	231	273						72
8,726	-6,321	-6,061	4,605	4,475	14,088	986	10,719	6,546	16,141	32,807	10,743	42,154	64,253	73
-1,516	-219	-2,779	-1,279	-2,634	-1,458	5,997	19,544	-2,823	12,540	1,139	1,152	1,995		74
										29,484	28,564	34,236	41,390	75
697	2,080	-2,280	-6,416	911	-5,305	2,981	-9,483	-21,801	-33,964	-27,565	-33,544	-28,087	-36,389	76
3,383	5,625	2,589	-1,941	11,021	9,147	22,749	9,205	-9,884	-10,340	4,696	7,477	11,353	-3,177	77
2,043	4,067	510	-3,822	9,976	7,437	21,631	7,354	-11,724	-12,270	2,166	5,130	9,141	-3,799	78
330	2,331	-1,435	-5,756	7,140	1,942	19,136	6,397	-14,511	-13,646	-984	431	4,982	-11,211	79
-1,179	2,681	2,349	-6	158	-1,467	949	-2,568	-375	722	-1,133	-8,155	-5,175	-4,965	80
-1,552	7,364	27,389	10,293	5,999	10,344	569	13,066	25,416	31,222	-13,824	14,821	5,458	2,668	81

APPENDIX

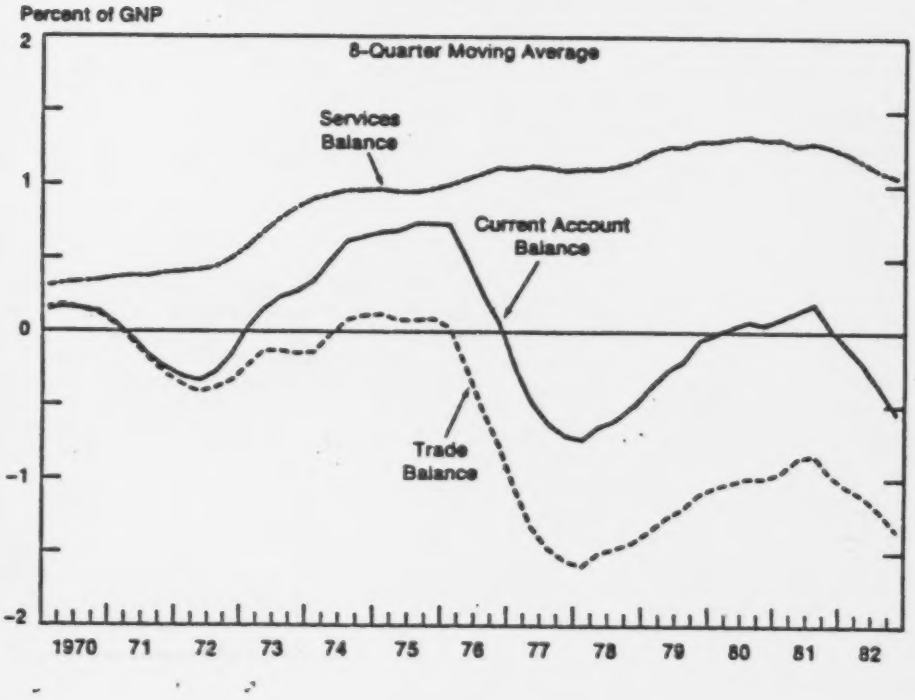
CHART



APPENDIX

CHART

Balances on Current Account, Trade, and Services as Percent of GNP



Statement of Senator Dole on the Trade Deficit

It is fitting that the Finance Committee should hold this hearing on the trade deficit within days of completing its efforts to reduce the Federal budget deficit. I am convinced that the Federal budget deficits, both current and projected, are the most serious problem confronting the United States, with implications which touch virtually every aspect of our national life. And if we need evidence of the damage perpetrated by these budget deficits, we need look no further than the trade and current account deficits of the United States. In 1983, the trade deficit reached $69.4 billion and current account deficit exceeded $40 billion. These are staggering figures, and they are made even more troubling by the prospect of a 1984 trade deficit of over $100 million and a current account deficit of over $80 billion. These deficits are expected to continue into 1985.

What is the meaning of these immense figures? We hope today's distinguished witnesses can help this committee understand the consequences of this massive imbalance. But some consequences are painfully obvious. American industries which must compete with cheaper imports find themselves at a significant disadvantage through no fault of their own because of the high exchange value of the dollar. A similar effect is felt by our exporters, who find themselves priced out of foreign markets by the high exchange rate of the dollar. Some economists argue that these effects are mitigated by the benefits of low inflation and high consumer purchasing power, but it seems to me this analysis is a bit cavalier about the human costs of these forces, and their effect on the structure of our economy.

It is disturbing to note, for example, that the deterioration has been concentrated in the manufacturing sector, which accounts for about two-thirds of our total trade, where the U.S. balance shifted by nearly $30 billion between 1982 and 1983. If this trend continues the U.S. manufacturing sector will shrink, and that will diminish the benefits which this high-value-added sector can contribute to our economy.

It is also apparent that by running these massive current account deficits, the United States is rapidly liquidating its position as a creditor nation. Without judging whether this trend is good or bad, it does point to the day when we will be forced by events, or by an institution like the International Monetary Fund, to impose painful austerity measures.

While the reduction of the Federal budget deficit must be our first priority in reducing the U.S. trade deficit, I am not persuaded that other measures would not be effective. We hope the witnesses today will address some of these alternative measures. I note for example, that the administration has steadfastly ruled out exchange market intervention or import surcharges. But it is hard to accept that we must stand by helplessly as this situation deteriorates.

One of the problems is that the administration does not appear to agree on the nature of the problem. I note, for example, that the Treasury Secretary recently stated that the dollar is not "overvalued" while the Council of Economic Advisers says that the dollar is 30% overvalued and may take ten years to return to more appropriate levels. At the least, we hope this hearing has provided the administration an occasion for reconciling different approaches to the problem.

The difficulty of ruling out all measures to reduce the trade deficit other than cutting the Federal budget deficit, is that we have witnessed the political difficulty of getting action on budget deficits. And in the absence of more dramatic cuts in Federal budget deficits, our economy may be caught between the strong dollar with continuing and debilitating trade deficits, and a plunging dollar with inflation or high interest rates and recession.

Statement by Senator Max Baucus

Thank you Mr. Chairman.

I commend you for holding hearings on this important and timely subject.

TRADE: A TOP PRIORITY

Trade issues are more important than ever before. Seventy percent of American products now face international competition. As a result, our economy really is the world economy. Jobs in Butte depend on the government policy of Zambia and consumer spending patterns in Taiwan.

How have we adjusted to international competition?

Well, the figures don't look good.

The Commerce Department recently announced that, in January our monthly trade deficit hit $9.5 billion. At the rate we're going, in 1984, our annual trade deficit will exceed $100 billion.

What does this mean?

First and foremost, it means U.S. companies are losing sales, at home and abroad. And this means that over 3 million jobs are shifting overseas.

AMERICA'S RESPONSE

How can we recapture these lost sales and lost jobs?

First, we must excel. Our managers must be the sharpest. Our workers must be the best.

But let us not kid ourselves. In the real world of today's international marketplace, building a better mousetrap is not enough.

You can excel through your own efforts of creativity, economy, and hard work. You can make the best products at a fair price.

But, whether you are a steel producer in Pittsburgh, a cattleman in Montana, or a small high tech manufacturer in Silicon Valley, you will be unable to compete if your price is inflated in the world market by an overvalued dollar.

Your best efforts will go unrewarded when your products are barred entry by tariff and nontariff barriers imposed by our trading partners.

So, to compete, we must first tighten up our trade policy. Among other things this means reducing the budget deficit and taking measured retaliation against unfair foreign competition.

REDUCING THE BUDGET DEFICIT

Let me talk about the federal budget deficit first, because it is our major trade problem.

The budget deficit is increasing by $22 million an hour. It's keeping interest rates high. And that's keeping the dollar overvalued.

This cuts us with a two edged sword.

On the one hand, our exporters see their prices artificially hiked 25% or more. This leaves them uncompetitive in many markets abroad. A pound of Montana beef costs the same or less as a pound of Australian beef. But the inflated dollar gives that pound of Australian beef a 25% price advantage.

At home, our firms face strong competition from imports which enjoy a de facto price subsidy because of the inflated dollar. Price conscious American consumers discover that "Buy American" means "pay more." American manufacturers, for their part, find they cannot compete even for their traditional domestic markets unless they use more imported components for their products.

The danger is clear. Finally, we may be working out the beginning of the solution. The members of this Committee, of course, have spent the last four months, including most of the last 3 weeks, drafting the heart of a deficit-reduction "down-payment" package of about $150 billion, split between spending cuts and tax increases.

It's been tough. I've voted for Medicare cuts I don't like. And I've voted for tax increases I don't like. But someone has to get the ball rolling, and I'm proud of our work.

But this is just the beginning. We will need support from our colleagues and our constituents to get this package enacted. Even if it does survive the many tests it will face, let us not forget that it is only a "down payment." Our next and more critical task will be to fashion a deficit reduction package that will result in a stable dollar more reflective of our international trade position.

BREAKING DOWN TRADE BARRIERS

The second priority trade issue I have focused on is breaking down the barriers our trading partners have erected against our exports.

When we sit down with the Japanese, Canadians and Europeans, the words "free trade" no longer mean much. Instead, we now bargain over what we call "fair trade."

Some economists refuse to admit that "fair trade" has any meaning. But they are not living in the real world.

Free trade is an ideal; fair trade is an achievable goal.

I define fair trade as reciprocal policies by trading partners that permit broad access for the products these countries produce competitively.

In the case of Japan and the U.S., for example, America already provides broad access for the many manufactured goods the Japanese produce competitively. But the Japanese do not reciprocate.

They limit entry to our agricultural products, communication equipment, and high tech goods that could help reduce our huge deficit with Japan.

The figures are striking. In 1983, we exported to Japan $21.9 billion. They exported to us $41.2 billion. Almost double our total.

And yet they persist in keeping our competitive products out of their market.

They claim they have the lowest tariffs of any industrialized country in the world. And, on the whole, that's correct.

But this is where we can separate free trade arguments from fair trade.

While their average tariff level is low, their tariff and non-tariff barriers on goods they do not produce competitively are among the most restrictive in the world.

It is easy for the Japanese to eliminate their tariffs on televisions, pocket calculations, and small cars. There is minimal foreign competition.

But try to get them to drop their barriers on beef, citrus, or high speed communication equipment. They retreat to protectionism every time.

AMERICA NEEDS TO GET TOUGH

We are now in the middle of seemingly endless rounds of talks with the Japanese and the EC on removing trade barriers. We have yet to get tough with the Japanese, and our trade deficit reflects this policy weakness.

When we finally decided to strike a sharp chord with the Europeans, they responded. Our threat of enacting the Wine Equity Act has led the EC to back off on its intention to sharply cut our sizeable exports of corn gluten feed.

Our cycle of retaliation with the Europeans now is at a standstill. The Wine Equity Act has awakened them to the potential damage a full scale trade war could lead to.

We have got to also get tough with the Japanese.

We need to remind them of an old Japanese proverb that says "The sack of a man's patience is tied with a slip knot."

They keep footdragging and we keep paying homage to the threat of retaliation. That won't work. They think we don't care, and to some extent they are right.

To show my resolve on an issue that has become a symbol of Japanese unfair trading barriers—Japanese beef import restrictions—I have announced my intention to tie my vote on domestic content legislation to the outcome of the beef talks.

I reached this decision with great reluctance.

I am convinced now more than ever that it was the right decision. The Japanese are tough negotiators, and they understand one thing: power. We must show them we have it and will exercise it in the pursuit of fair trade.

CONCLUSION

Mr. Chairman, when I look at America's economy today, I am deeply troubled.

I see America's industry unable to compete in the international marketplace.

I see America's firms unable to sell their products in America without importing more components from abroad.

I see our research and development efforts lagging behind those of our chief competitors.

And I see our corporations all too often focusing their efforts more on creative accounting than on making a better product.

I fear America may be following the downward economic path of the initiator of the industrial revolution—Great Britain.

We can prevent this from happening. But we must start now.

Let us first create an environment for America's firms to compete in the international marketplace.

This requires:

Reducing the budget deficit which will lead to a healthy but more appropriately valued dollar.

Breaking down trade barriers abroad.

Removing unnecessary disincentives our own government puts on our exporters.

We must then look inward and take steps to reverse the decline suffered by our manufacturers and processors, industrial and agricultural.

We must create lucrative incentives for research and development.

We must reward those entrepreneurs who will take the large risks required in establishing and expanding productive facilities.

We must apply our new technologies to producing more and better products, not just more and not always better services.

And finally, we must foster a new attitude in America: An attitude that we can produce and sell competitive products if our entrepreneurs, workers, and retailers make that extra effort.

A producing, competitive America is the only long-term answer to eliminating the trade deficit.

Thank you, Mr. Chairman. I look forward to discussing this important topic with our distinguished witnesses.

STATEMENT OF SENATOR LLOYD BENTSEN

Mr. Chairman, I want to commend you for having this hearing. We hear a lot of talk about the budget deficit—and the Administration's steadfast refusal to deal with the problem. We hear less talk about the trade deficit, which—in many respects—is a byproduct of irresponsible budget policies.

The fact, Mr. Chairman, is that American trade policy is drifting aimlessly. And that drift couldn't occur at a more dangerous time.

We are looking at the very real possibility of $100 billion trade deficits. The dollar is overvalued by up to 20%. It's small wonder we're having trouble competing. The time has long since passed when the United States can spot nations like Japan and Germany a 20 yard head start and still hope to win the 100 yard dash for world markets.

One would be tempted to assume that with the size and importance of our problems, trade would be an urgent priority with this Administration.

But that is not the case. Trade apparently is not important enough to be placed on the President's agenda. Oh, I know the Administration wants trade reorganization and a new round of talks. But, Mr. Chairman, you don't change the deck by shuffling the cards. Reorganization and negotiation are no substitute for a coherent, comprehensive, realistic trade policy.

We're learning a lesson well known to the weekend sailor, Mr. Chairman, when you don't know what port you're headed for, there is no such thing as the right wind. Rather than set a course the Administration prefers to drift through a fog of monetarist indifference and tell the American people: Don't worry, we'll come out where we want to if we just stay the course."

Mr. Chairman, irony is a thread that runs through the maze of the Administration's refusal to face up to the realities of trade. The Administration talks about free trade, but through their indifference they make it very difficult to remain a free trader up here in the Congress.

We have reputable members of the Senate flirting with the idea of an import surcharge. And I can understand why that is the case. The easy thing for me, Mr. Chairman, would be to sit here, decry the injustices in the world of trade, and demand that the United States take retaliatory measures.

We've become so accustomed to the idea that the rising tide of trade lifts all boats that we've lost sight of the fact that our own boat is sinking like a rock.

It was easy to be a free trade advocate back in the heady days after World War II when the United States owned the world economy and trade was only 4% of our GNP.

But now trade is 12-15% of GNP and this country is not meeting the terms of competition. Our exports of manufactured products has not quite doubled since 1967. Japan's have increased fivefold; France's threefold.

By the end of this decade, Mr. Chairman, ten to fifteen million American industrial workers will become permanently displaced by technology, import competition, and other fundamental economic changes. Yet we spend less money retraining these workers than we collected in customs receipts at Savannah, Georgia, in 1982.

Unless we make some significant, dramatic changes in the very near future we could be writing off America's ability to compete; we could become a nation of hewers of wood and carriers of water for the industrial states of the future.

I still consider myself a free-trader, Mr. Chairman, and I honestly believe that free trade can help control inflation and improve productivity by concentrating our people in the jobs they do best.

But we champions of free trade could make a much stronger case if the rest of the world would open their markets the way we have opened ours. Most of our so-called partners in trade are following mercantilist policies—the very antithesis of free trade. We are seeing whole nations being organized to provide export-led growth—most of it in our markets. The model of international economic success in the eight-

ies is not the open US economy, Mr. President, it is the closed Japanese market and a ruthless talent for targeting.

For an Administration so enamored with the theory of free trade, it is strange indeed to see that the most notable elements of a trade policy involve protection for American steel, specialty steel, automobiles, textiles, and motorcycles.

So, Mr. Chairman, is it any wonder that people are confused? Should it come as a surprise when Americans look at the trade figures and start to ask some questions about free trade? Does anyone dispute the fact that it is almost impossible to compete for trade these days when your currency is over-valued by 30% because the Administration turns its back on $200 billion budget deficits?

The problem is self-evident, Mr. Chairman. It is there for the world to see. It is a trade deficit that grows geometrically, costs us millions of jobs, and places our future competitiveness in jeopardy.

The answer is less obvious. It is not protectionism. It is not endless negotiations. The answer is going to involve a concerted national effort to develop a trade strategy.

We must accept and prepare for the inevitability of change. We must develop an ability to adjust to work-class competition.

No American company should be allowed to formulate a corporate strategy in the mistaken belief that it has an innate right to the American consumer's income. But, by the same token, no foreign producer should be allowed to believe he has a right to the American market on any terms other than those that apply to his American competitor.

America is not without leverage in the world of trade. We have the world's largest and most open market. We are the target. Let's use that leverage to demand reciprocity. Let's make it clear to our competitors that we are serious; that we will accept the discipline of trade, but not the distortions caused by some nations insisting on "export only" policies. Today we're in the ridiculous position of leading the march to open markets, but no one is following.

You don't need to be a trade expert to appreciate that a well educated, highly trained work force is essential to any nation's ability to compete.

The Administration's budget asks for $7.3 billion for education in FY 1984, Mr. Chairman, but they have actually reduced vocational education funding. There is no funding to carry out the teacher training recommendations of the President's own Commission on the subject. "A Nation at Risk," that seems to have been lost in the the White House.

When it comes to controlling unfair imports, Mr. Chairman, our policies must do many things well. They must be easier to use and to administer; they must hit real unfairness with more accuracy. They must avoid setting bad precedents for other countries to use against us. And they must not destroy productive incentive. Compared to such finely tuned machinery our current trade policies are Rube Goldberg contraptions.

The Administration thinks subsidization on specialty steel is a bad thing, but instead of taking action under section 301 of the Trade Act to do something about the subsidy, they simply protected that industry and thereby lost us millions of dollars of export sales of sporting equipment and chemicals by way of retaliation. The Administration thinks export targeting by Japan is unfair, and they have been talking to Japan about it. Period. The Administration cannot agree on how antitrust policy fits with trade policy, how budget deficits fit with election year politics, or whether we have got a beef with Japan.

Mr. Chairman, we all know the story of the Eastern Monarch who asked his wise men to produce a sentence that would be true and appropriate at all times and occasions. They came up with "This too shall pass." Well, I suppose our trade problems and deficits and the crisis in our ability to compete will pass, but at what cost?

As the economist David Richardson has pointed out, "Temporary real impacts that persist for two or three years stand a good chance of permanently affecting personal productivity and industrial viability."

Mr. Chairman, unless we face up to the facts of trade and take prompt, courageous action to develop a trade strategy, I really despair of our future ability to compete. And I shudder to think what that would imply for our future as the most prosperous, productive, and powerful nation in the world.

STATEMENT BY SENATOR GEORGE J. MITCHELL

Mr. Chairman, I congratulate you for holding a hearing on such an important subject. In my assessment, the growing trade deficit is the most tangible evidence of

the harmful effects of the massive federal budget deficits. I hope that the testimony we receive today will confirm the view that immediate action on the budget deficit will produce favorable economic effects and that there is substantial risk in doing nothing.

The fact is that the impressive growth in the economy masks significant weaknesses, the worst of which is last year's record $69 billion trade deficit. Our weakness in the international economy has been a major drag on this recovery. And it is a serious threat for the future.

Our international economic performance is best measured by the merchandise trade deficit. That is the difference between the value of goods imported into the U.S. and exports of U.S.-made products sold abroad. Any nation which sends abroad more purchasing power than it attracts faces serious trouble down the road.

In 1982, the U.S. set a record trade deficit of $43 billion. In the first nine months of 1983, that record was broken. The total trade deficit for 1983 was $69 billion, an increase of over 50 percent in one year. And virtually all forecasters, including Administration forecasters, expect the 1984 trade deficit to exceed $100 billion.

Although we have traditionally enjoyed a surplus in the export of services, that surplus has not kept pace with the ballooning merchandise deficit. The gap between what we import and what we export has widened dramatically.

Directly, that means lost production and lost jobs here in the United States. Estimates of the job loss alone range from between 1.5 and 2 million jobs.

That is a staggering loss of jobs. The jobs bill Congress passed at the depths of the recession, by comparison, was not expected to generate more than 200,000 jobs, less than one-seventh of the jobs lost through the trade deficit.

That job loss, in fact, is almost one and a half percent of our total labor force. In other words, if our trade position had stayed the same, and not deteriorated, the unemployment rate today could be as low as 6.5 percent.

Surprisingly little attention has been paid to this glaring weakness in our economy.

Until recently, international trade was not considered an economy-wide problem, but rather a limited problem, affecting only the domestic industries that face stiff import competition, industries such as autos, steel, and footwear.

But that narrow view is not just archaic, it is manifestly wrong. Trade-related production losses and job losses are spread throughout the manufacturing sector. They affect firms that compete with imports. But they also affect firms that depend on export markets, such as firms in the high-tech and capital equipment industries.

So the trade deficit is not limited to 200 footwear workers losing their jobs in Saco. It has implications far broader for all businesses and all workers, whether they are directly threatened by imports today or not.

It is no coincidence that we are setting record trade deficits at the same time that the federal budget deficit is reaching unprecedented levels.

Businessmen understand that high budget deficits can "crowd out" investment by forcing business credit needs to compete against government borrowing needs, because the government will pay whatever it must, and businesses cannot compete with that.

A similar but less well known relationship exists between the budget deficit and the trade deficit.

Heavy federal borrowing pushes up interest rates. The massive deficits of the last three years have made interest rates in the U.S. very attractive compared to other foreign capital markets. Interest rates in the U.S., for example, currently exceed the inflation rate by about 8 percent. In Japan, interest rates are only about 3 percent over inflation. U.S. financial markets today offer a very attractive return on investments, and a rate of return that is matched nowhere else in the world.

So foreign capital has been flowing into the U.S. to take advantage of those high interest rates.

But to enter U.S. financial markets, foreign investors must purchase dollars. Competition for dollars has pushed the value of the dollar up sharply in the last three years. According to the President's Economic Report, at the close of 1983 the value of the dollar was up by more than 50 percent over its 1980 value.

A strong U.S. dollar automatically makes our businesses less competitive. Our exports cost buyers more in foreign markets. Their products cost our consumers less in our domestic market.

The sheer magnitude of the dollar's rise since 1980 has had a devastating impact on U.S. competitiveness. It is also a largely artificial impact, since it stems directly from currency values, not from productivity or materials costs.

The effect of a 50% upward revaluation of the dollar is precisely the same as if we imposed a tax of 50 percent on our exports and gave a subsidy of 50 percent to imports. No businesses can compete with such a price disadvantage.

This fact explains the difficult plight faced by many industries. The footwear industry has seen the import share of its market rise from one-half in 1980 to almost two-thirds in 1983.

And other Maine businesses can testify to the effects of this upward swing in the value of the dollar.

As a border state, Maine is particularly affected by the rise of the dollar against the Canadian dollar. Although that rise has not been a full 50%, our dollar has appreciated by about 20 percent since the mid-1970s. This means lost sales for Aroostook County potato growers, who compete with Canadian imports. It means lost business for Maine tourist centers, which lose Canadian tourists because of the greater expense to them of visiting the U.S.

The normal experience is that huge trade deficits are more or less self-correcting. Large trade deficits mean that foreign currency markets build up an oversupply of the currency of whatever country is running the deficit. That oversupply, itself, moderates the value of that currency against others. And that country's goods therefore become more affordable and more competitive in world markets.

In normal economic circumstances, we could expect to see such a self-correction take place with respect to our dollar. As we ran a deficit of $69 billion last year, foreign currency markets should have more than enough American dollars, and their value should fall relative to Japanese and other world currencies. Our manufacturers' goods should again become somewhat cheaper for foreigners to buy.

But that is not happening. And the reason that it is not happening is that our domestic budget deficit is keeping interest rates so high that even though there are huge amounts of dollars available on foreign currency markets, foreign investors are buying them up in order to be able to invest them in U.S. securities.

So even though we are running a huge trade deficit, our manufactured goods are still overpriced by international standards. And imports into our domestic economy still enjoy a substantial price advantage because of the overvalued dollar.

We cannot run a trade deficit of this magnitude without risking our economic future.

The impact of the trade deficit should effectively rebut the claim of those who argue that the domestic budget deficit is doing no real harm and that action on it can therefore afford to wait until after the 1984 elections.

Unfortunately, many officials in the Reagan Administration seem to believe this. Recently Treasury Secretary Regan told the Senate Finance Committee that, "It would be very difficult to demonstrate that these deficits exerted any very harmful effects last year, or are likely to do so this year."

The poor performance of firms that compete internationally should be enough, even for Secretary Regan, to recognize that his statement is wrong.

The reality is that trade-related firms constitute a major weakness in the economy. Up to 60 percent of American firms must now compete actively with companies based either abroad or multi-national American firms. Some of these companies are questioning the wisdom of investing further in the U.S.

But the net effect on our economy and our prosperity is the same. Goods produced abroad provide no jobs here. Factories established abroad reduce the modernization of firms occurring here. If we do nothing to reverse the uncompetitive realities facing business, we are inviting a future deindustrialization of serious proportions.

The single most effective action we can take now is to reduce the deficits to bring down those interest rates which contribute so much to our overvalued dollar.

But the Administration seems willing to gamble that inaction on the deficit will cause no serious harm. The President's budget for 1985 offers no progress in reducing the deficit. And it projects that we will have deficits of $180 billion through 1987.

It is not surprising that many forecasters doubt that a sustained recovery is underway.

The rise of these non-tariff barriers represents the major challenge to the international trading system. Open trade is being undermined by the short-term—and short-sighted—efforts of various governments to maintain their existing advantages in trade and to gain a foothold in new markets.

These practices are widespread. A recent report estimated that one-half of all international trade is affected by non-trariff barriers. The General Accounting Office found that three of our major trading partners, Japan, France, and the United Kingdom, are currently subsidizing one-third of their exports.

Canada is a near example of a country with myriad trade-distorting policies. It has extensive regional and industrial subsidies that give Canadian producers a competitive advantage in the world marketplace. Canada also imposes significant requirements on foreign investments that can have the effect of displacing U.S. exports.

And like the nations of Europe and Japan—and unlike the U.S.—Canada actively develops and pursues a trade policy. By contrast, international trade is a stepchild of American domestic and foreign policy.

Trading relationships are forced to carry other foreign policy demands. In recent years, for instance, the Reagan Administration's demand that the Soviet Union be denied the fruits of U.S. technological knowhow disrupted American involvement in the building of the trans-Siberian pipeline. It did not disrupt the building of the pipeline itself. But it did seriously disturb relations with our allies, not our adversary. And it undermined the credibility of American firms in competition for overseas contracts.

The serious danger is that this state of current events could easily lead to a strong resurgence of protectionism with no off-setting policy of reducing trade barriers.

I believe that trade must be both fair and free. And to that end, I have supported and sponsored legislation designed to improve the functioning of our own trade laws when the trade practices we face are blatantly unfair and uncompetitive.

The current operation of our anti-dumping and countervailing tariff procedures are so lengthy, so costly and so confusing that it is not surprising that our industries are subjected to blatant competition from subsidized imports. What is surprising, given the nature of our procedures, is that the International Trade Commission is being faced with a record number of anti-dumping and countervail cases right now.

What we must do, in my view, is to streamline those procedures so as to give notice to all our trading partners that if unfair trade is practiced against this country, we will respond promptly and effectively.

The unwillingness of the Administration to recognize and speedily redress the unfair competition that some of our industries face is not only contributing to the trade deficit, it is encouraging other nations to view our markets as fair game for any kind of unfair trade practice.

This must stop. And it seems to me that the only way to effectively stop it is to streamline procedures so that other governments recognize that we are serious about fair trade, as well as free trade.

I do not believe we can abandon the American ideal of open trade. Nor do I believe there is any need to abandon the American ideal of fair trade. If the one can be linked directly and clearly to the other, we will establish a system in which our trading partners will recognize that fair trade is to the advantage of all, and that from it, free trade will easily follow.

The CHAIRMAN. I want to thank the witnesses who will be meeting with us this morning. Obviously, the trade deficit is a matter of great concern. We are looking at a current account deficit of over $80 billion and are expected to continue into 1985.

In my view, we need to determine the meaning of these immense figures, and we hope that the witnesses today can be helpful in that area. We have had an informal discussion next door with Ambassador Brock, and that's why we're a bit late.

But the consequences I think to many are painfully obvious. American industry, which must compete with cheaper imports, find themselves at a significant disadvantage through no fault of their own because of the high exchange value of the dollar. A similar effect is felt by our exporters, who find themselves priced out of the foreign market by the high exchange rate of the dollar.

Some economists argue that these effects are mitigated by the benefit of low inflation and high consumer purchasing power, but it seems to me that there is some reason to dispute this analysis.

It is disturbing to note, for example, that the deterioration has been concentrated in the manufacturing sector, which accounts for about two-thirds of our total trade, where the U.S. balance shifted

by nearly $30 billion between 1982 and 1983. If this trend continues, the U.S. manufacturing sector will shrink, and that will diminish the benefit that this high value added sector can contribute to our economy.

It is also apparent that by running these massive current-account deficits, the United States is rapidly liquidating its position as a creditor nation. Without judging whether this trend is good or bad, it does point to the day when we will be forced by events or by an institution like the International Monetary Fund to impose painful austerity measures.

Mr. Ambassador, we are pleased to have you here, and your entire statement will be made a part of the record. You may proceed in any way you wish.

Senator BENTSEN. Mr. Chairman, there will be others of us who would like to introduce statements, at whatever time you will allow us to.

The CHAIRMAN. Fine. We can do it either way. You may as well do it right now.

Is that all right, Bill?

Ambassador BROCK. Sure.

Senator BENTSEN. Mr. Chairman, I really believe that American trade policy is drifting aimlessly. We are seeing in the administration itself crosscurrents with substantial disagreement as to how we ought to approach this problem.

Much of the problem comes from the fact that we have had some very irresponsible deficits in the Federal budget and we have not properly addressed those deficits. I think this committee has made some headway on that last week, and I congratulate the chairman for that; but when we get in a situation of a 20- to 30-percent differential in exchange rates, a situation where in effect you are saying to the foreign markets that "In a 100-yard dash to the marketplace, we are going to give you a 20- to 30-yard headstart on us." Obviously we can't afford that kind of a differential in the competition today.

I really don't think that you are going to resolve the problem, either, by just trying to reshuffle the deck by trying to set up a Cabinet-level trade department that tries to reassign the responsibilities and the people that might take on that responsibility.

Mr. Chairman, I am delighted to see Ambassador Brock here. He is a man facing an extremely difficult problem with us looking at some $80 to $90 billion deficit in trade. We have a situation where we have not had the proper reciprocity We have nations that think they have some moral rights to our markets now. We have reduced our tariffs to such an extent that we have not a great deal of bargaining power left, unfortunately, and it's certainly not an even playing field.

Mr. Chairman, I would like to put the balance of my remarks in the record in their entirety.

The CHAIRMAN. Does anyone else have a statement they would like to make?

Senator CHAFEE. I would just like to say, Mr. Chairman, that I would hope that in these hearings we would concentrate on what we can do, the United States, to straighten out our own situation, rather than spending too much time belaboring the competitive

edge that other nations have obtained through hard work, balancing their budgets, and other efforts.

We should make greater efforts to remove disincentives to trade, such as the Senate bill we passed 3 years ago to amend the Foreign Corrupt Practices Act. The bill has again been reported by the Senate Banking Committee, and which remains pending in the Senate, partly because it seems hopelessly bottled up in the House.

So I hope that this wouldn't be a trip to the Wailing Wall, to bemoan what others are doing, but would concentrate what we can do to correct our own problems.

Thank you, Mr. Chairman.

Senator HEINZ. Mr. Chairman, the only other observation I would make is that we are going to hear today about how our high budget deficit is hurting our trade picture and creating huge trade deficits.

Fred Bergsten is going to be one of our witnesses. I remember Fred testifying in 1978 and 1979 about how the weak dollar was creating a big trade deficit. And indeed we had a trade deficit under both circumstances.

Now, the easy answer to that is, "Well, we were importing too much then, and we're not exporting enough now;" but if we hide behind those macroeconomic simplicities, we are never going to get to the bottom of the problem.

I really want to second what John Chafee said, which is that there are questions of the extent to which we are limited in going into other people's markets—I know Bill Brock feels that way.

There is also the equal question of unfairly traded imports coming into this country, dumped and subsidized; there are patent and trademark piracy issues rampant, particularly in the Far Eastern countries, but not there alone—some of the South American countries aren't very good on it, either. There is the failure of U.S. companies to improve productivity, or when they do ignore it to have those gains snatched right away from them.

We do not have an adjustment policy in this country that has any meaning at all. It is especially true for declining industries. And, finally, we have the interesting and, for us, I guess, nice fact, that we politically are very attractive as a place for foreign investment, for foreign capital. We are a safe haven. I don't want that to change, but I think we need to recognize that world politics plays a part in the strength of the dollar, too, not just the budget deficit—even though I suspect that this committee is unanimous about how it would like us to do still more on decreasing the U.S. Federal budget deficit. In short, Mr. Chairman, there are numerous issues beyond macroeconomic theory we should consider as well.

Thank you, Mr. Chairman.

Senator MITCHELL. Mr. Chairman, I have a statement, but in the interests of time I will ask that it be inserted into the record.

The CHAIRMAN. All right.

Senator Baucus?

Senator BAUCUS. I have the same request.

The CHAIRMAN. Senator Long?

Senator LONG. No statement, Mr. Chairman.

The CHAIRMAN. Mr. Ambassador, you may proceed.

STATEMENT OF THE HONORABLE WILLIAM E. BROCK, U.S. TRADE REPRESENTATIVE

Ambassador BROCK. Thank you, Mr. Chairman.

I am delighted to be back with you, but I can't say I'm happy about the subject, because it isn't easy, and it is a good deal troublesome.

Since our trade deficit is such an important subject and one where we are not at a loss for opinions on the causes and effects, I will limit my remarks to a few brief points and try to have as much time for discussion or dialog as I can.

Let me just list three major causes underlying the current trade deficit and discuss each one very briefly:

First, our rapid and strong economic recovery. It has been sooner and stronger than in virtually any other part of the world. Imports, because of that, have been drawn to our country, while the demand for our exports has lagged substantially in all parts of the world.

Second, and a major problem, the international debt crisis, which has depressed economic expansion in many advanced developing countries. Rising oil prices? We have had in those countries effectively three oil shocks—the first, embargo; second, the Iranian-Iraqi war; and the third caused by the explosion in the value of the dollar.

Those three oil shocks, coupled with exploding interest rates and deepening world recession after 1979, left a number of those LDC's with external debts totaling $664 billion in 1983. And in their judgment they have had to cut back their imports by about 40 percent to service this debt. This is most significant in Latin America where the United States has strong trading interests.

I think one point would illustrate the magnitude of the difficulty. You take the eight high-debt Latin American countries; our trade circumstance deteriorated by $20 billion, from a surplus of $5.8 billion to a deficit of $14 billion, in just the 2 years 1981 to 1983. I want to note that this is two-thirds of the total deterioration in our trade deficit during that 2-year period.

So, you can talk about a lot of factors, but the largest single factor in the deterioration of the balance can be laid at the doorstep of this debt crisis.

So I think it is important to note that supporting these countries and adjusting to the debt burden through a financial assistance and—and I stress this, please—open markets here and in the other industrial nations. It is not only in their interest, but in our own. It is crucial to a strong expansion of our exports, to keep our markets open for their product.

One critical tool that I would make special reference to for these countries is the GSP, Generalized System of Preferences Program. It does assist them in earning the foreign exchange needed to honor their debt and to buy our product, and I need not point out that the extension of GSP is before this committee. I hope that we can anticipate early and affirmative action in giving that program another 10-year lease on life.

The third element in the trade deficit that I would like to mention today is the value of the dollar that was mentioned by a number of members of this committee.

Since 1978, the dollar has appreciated effectively about 40 percent vis-a-vis the currencies of the world. It varies from about 80 percent vis-a-vis the franc to a good less than 40 percent vis-a-vis the yen; but in overall terms, it is about 40 percent.

The determinants of the value of the dollar are both numerous and complex. I think it is clear that the current value is being supported by a significant movement of foreign capital into the U.S. market.

There is a lot of good reason for that. As Senator Heinz has mentioned, we are the safe haven. We are the world's most stable and prosperous economy, both in political and in economic terms. It is not illogical that the dollar is the world's crisis currency, that it is the world's safe haven currency, and I am not sure that any of us would want it to be otherwise.

So there is nothing we can or should do to reduce this side of the problem.

If we do not question the desirability of open investment problems, and I don't believe that any of us have, that does leave, then, the question of high interest rates. Those in part result from the fact that what our Nation saves these days is not sufficient to both cover Federal deficits and supply all the product credit needs required for economic expansion.

I would conclude this mention of the dollar by simply stating for the record, in the strongest possible terms, that we cannot have sustained economic expansion at home and a more competitively valued dollar unless we can substitute increased domestic savings for foreign credits. We cannot long rely on the importation of money to finance our own economic progress.

Let me just, then, deal with what I think is one erroneous impression that has crept into the discussion that surrounds the trade deficit. That impression is that our deficit is the result of a deterioration in the fundamental competitiveness of U.S. industry. I don't believe it. I don't think there is any documentary evidence to justify it. And I think it is important to note a couple of facts in this connection:

First, since 1970, industrial production in the United States has surpassed that of Canada, Germany, France, Britain, The Netherlands, and any number of other countries. Since 1970, our domestic industrial production has risen by 41 percent, a remarkably good growth rate in a very difficult period.

Whatever the impact of the domestic determinants of long-term competitiveness such as innovation, investment, and productivity, they have not led to U.S. disindustrialization, nor do they account for the recent sharp increases in the U.S. trade deficit. And to a large extent, the size of our trade deficit is the result of the world macroeconomic factors, as I have testified; but it is not—it is not—the result of a broad-based decline in industrial competitiveness. As a matter of fact, in almost any rational analysis of the United States in terms of productivity on a per capita or on a gross basis, the United States remains far and away the most competitive and the most productive nation in the world today.

I don't want to concentrate totally on macroeconomic factors; increased market access for our exporters, the elimination of unfair trading practices—mentioned again by Senator Heinz—are of con-

sequence. But I do think that the growing size of the trade deficit is for the most part not directly caused by either U.S. trade policy or foreign trade practices. In fact, attempts to use trade policy to reduce the current deficit may worsen rather than improve the situation. And I have reference, for example, to proposed action under section 122 to the Trade Act, to impose an across-the-board surcharge on imports.

Let me just point out to you that that kind of action would not just reduce imports, but it would have the perverse effect of strengthening the dollar, or certainly moderating any further decline.

The surcharge, then, would, in effect, compound our difficulty and make it more difficult for us to compete overseas and here at home.

Then if you want to look at the future, I think there are a couple of cautions that are in order:

First, I think we simply have to accept the fact that even a substantial weakening of the dollar will require 12 to 18 months to positively affect our trade balance in great substance. So it isn't going to be an easy time that we face ahead of us, despite the recent reductions in the value of our currency.

The most important step remains: the reduction of the Federal deficit spending and increased domestic savings.

The effort to deal with the Third World debt problem is in large measure, dependent upon our integrity and ability in resisting protectionism here at home, because if we don't do that, then the hazard that we have faced in the last 2 years, with a $20 billion negative swing, will be only the beginning of a further negative swing in our trade account. In other words, protectionism will make matters far worse than the present circumstance, and the present is bad enough.

I think it is important that we turn our efforts to expansion, to growth. And in that connection I would simply cite the need for congressional action on things such as Senator Chafee's foreign correct practices bill, the bill sponsored by Senators Danforth and Bentsen, the reciprocity bill, the renewal of our Generalized System of Preferences Program, and extended negotiating authority to open up new markets for U.S. products.

If I may, I will simply stop at that point and see where you would like to go with questions.

[Ambassador Brock's prepared statement follows:]

STATEMENT BY HON. WILLIAM E. BROCK, U.S. TRADE REPRESENTATIVE

I am pleased to be with you today to discuss the U.S. foreign trade deficit and the role of trade policy in dealing with this problem.

As we are all aware, our merchandise trade balance has deteriorated significantly since the beginning of the current recovery. I will touch upon several factors underlying our deficits in my testimony today. These will include: Our rapid and strong economic recovery, the international debt crisis which has depressed economic expansion in a number of advanced developing countries and the high international value of the dollar.

I will also discuss what I believe is an erroneous impression created by our rising trade deficit: namely that the deficit is the result of a broad-based deterioration in the fundamental competitiveness of U.S. industry. I will conclude by discussing the role of trade policy in dealing with the deficit problem: what trade policy can do,

what it cannot do and what I believe is the best course to follow under the current circumstances.

Before beginning my analysis, let me give you some figures that illustrate the magnitude of the deficit problems we are facing. In dollar terms, the deficit has grown from $40 billion in 1981 to $69 billion last year. Our own forecast is that the deficit may exceed $100 billion this year.

Within this overall deficit much attention has been focused on our large bilateral deficits with Canada and Japan. The deterioration of our trade balance, however, has actually been worse in other areas of the world. From 1981 to 1983 our trade balance deteriorated by $4 billion with Japan and $7 billion with Canada. With Western Europe our balance declined by $11 billion and with the non-OPEC developing countries by nearly $23 billion. Only a $20 billion improvement in our balance with OPEC due to moderating oil prices offset deterioration elsewhere.

The deterioration in our trade has been concentrated in the manufacturing sector. Our surplus in agriculture slipped only moderately, from $21½ billion in 1982 to $20 billion in 1983. Our agricultural exports have, however, fallen by more than $7 billion since 1981. Our petroleum imports dropped by $8 billion last year so that our deficit for all raw and semi-manufactured materials including petroleum actually declined from $49 billion in 1982 to $46½ billion in 1983. However, in the highly competitive and price-sensitive area of manufactures, which accounts for roughly two-thirds of our total trade, the U.S. balance shifted from a small surplus of $4 billion in 1982 to a deficit of $31 billion in 1983.

U.S. firms and workers especially in the traded manufactures sector have felt increased competition as our overall trade position has weakened. The volume of our manufactured exports has declined by nearly a quarter in the last three years while manufactured imports have risen by 23 percent. Our strong domestic recovery has provided some relief to U.S. producers facing international competition. Nevertheless, the reduced price competitiveness of U.S. exports in world markets and rapid increases in competitive imports have compounded the pressures on vulnerable sectors of the U.S. economy, especially in industries like autos, steel, textiles and footwear. And, domestic firms and workers under strong import competition have reacted by greatly stepping up calls for import relief.

Even when we consider U.S. trade more broadly to include services, the U.S. trade picture is one of a deteriorating balance. For over a decade our increasing surpluses in services trade have tended to offset merchandise trade deficits. Frequently when merchandise trade alone have been in deficit we have shown a small surplus in total trade in goods and services. In 1982 the balance on goods and services showed a deficit of $3 billion—a small amount in comparison to over $700 billion in total export and import transactions. In 1983 the goods and services balance slipped to a deficit of $32 billion. A strong dollar and poor economic performance abroad contributed to a moderate decline in our services surpluses. The surplus on private service industry trade, excluding earnings on foreign investment, fell from $7½ billion in 1982 to just over $6 billion in 1983. The surplus on foreign investment earnings likewise declined somewhat from $41½ billion to $36½ billion.

Many are legitimately concerned today about the impact of the trade deficit on our economy and problems such imbalances in world trade pose for our ability to maintain and expand the open world trade system. To develop effective methods for dealing with the trade problems which beset us requires some understanding of the cause of deficits and how we have arrived at this unprecedented situation.

The oil crisis of 1979/80 and the inflationary spiral which it aggravated, resulted in several years of world-wide recession. As a result, world trade declined by 1 percent in 1981, dropped another 6 percent in 1982, and grew only 1 percent in 1983. The deterioration of our trade position is in part attributable to an earlier and stronger recovery here in the United States than abroad. This is a normal circumstance in a world recovery as the economic leader draws imports from the rest of the world before demand for its exports rises. As the rest of the world experiences a stronger recovery, it will begin to boost our exports and improve our trade position. The somewhat weak outlook for economic expansion abroad in 1984 and even in 1985, however, could slow the improvement of our trade position. This is particularly true with respect to Europe where economic rigidities, subsidies and excessive economic interference by governments have sapped the dynamism of the continent. This is also true in many developing countries suffering under the burden of unprecedented foreign indebtedness.

Stronger growth abroad would help improve our trade balance and reduce current trade tensions. Throughout most of the post-war period, world trade was an engine of growth, expanding faster than world GNP and therefore stimulating world-wide economic expansion. Although there is little we can directly do to affect the internal

policies of foreign nations which reduce their economic performance, we can pursue cooperative efforts to get the trade-and-growth engine of the world economy functioning again. One of the most important challenges we face in the area of trade policy is, in fact, to start world trade growing once more.

There is wide recognition that international trade, investment and monetary policies need to be focused on the expansion of trade. In the current economic environment there is a particularly close relationship between trade and finance. Nowhere is this clearer than in the case of the high debt LDCs.

North-south trade grew faster than any other area of trade in the 1970s, providing a major stimulus to economic growth worldwide. During the 1970s, the LDC market for U.S. exports rose substantially. Their share of our total exports rose from 29 percent in 1972 to 35 percent in 1979. The growth was even stronger in manufactures where their share of U.S. exports rose from 28 percent to 38 percent. The strong export performance of U.S.-built machinery and other capital goods in the last decade was in part made possible by the strong markets in LDCs where such equipment is required for economic development purposes.

Rising oil prices, exploding interest rates and deepening world recession after 1979, however, left a number of LDCs with serious debt problems. The external debt of these countries reached $664 billion in 1983, up $52 billion from the previous year. Because of serious problems in servicing such massive debt, many developing countries have had to cut back imports by as much as 20 to 40 percent.

The debt situation has caused particular problems for our own exports. Well over one-third of the LDC debt and some of the severest problems in debt servicing are found in Latin America where the United States has particularly strong trading interests. The efforts of these countries to trim their imports have been strongly felt by U.S. exporters. From 1981 to 1983 our trade balance with the eight high debt Latin American countries deteriorated by a staggering $20 billion from a surplus of $5.8 billion to a deficit of $14.5 billion. This accounts for over two-thirds of the deterioration in our total trade deficit with the world in these two years.

Supporting the LDCs in adjusting to their heavy debt burden through financial assistance and open markets is not only in their interest but our own as well. It is crucial to a strong recovery of our exports. Let us not make the mistake we made some 53 years ago when another international financial and economic crisis led to the Smoot Hawley tariff. One of the few who spoke out against this ill-conceived act which had such disastrous consequences was a member of the Senate, a Democrat, I might add. Let me quote him.

"America controls about 70% of the world's gold. She is a creditor in enormous sums for many of the European countries, and is wanting to collect her money, while at the same time she is building up a tariff wall so prohibitive that other countries cannot send their products to America, and thus are prevented from paying the debts they rightfully and admittedly owe. These foreign countries are not to blame. They do not want a tariff war with us. They want to buy our goods, which we sell to achieve prosperity at home. But they have no choice. There is no way in which they can buy our goods unless we permit them to sell us something."

"In comparison with the same months a year ago our export business has fallen off at the rate of $2 billion per year, and the difference between this country's satisfactory and unsatisfactory business condition is in its export trade."

I have taken a personal interest in that statement because, as it turns out, it was spoken by William E. Brock, Senator from Tennessee, my grandfather.

In order to once again expand their imports, the high-debt LCDs will have to increase their foreign exchange resources through higher exports, foreign investment, multilateral assistance and better access to trade financing. Secretary Regan and I have worked steadily to develop better coordination between the trade and finance officials worldwide as the linkage between the indebtedness of these countries and their trade practices has grown. It has been especially important that financial and other measures taken to assist high debt LDCs support a rapid recovery of world trade. We have provided Eximbank guarantees and insurance and Commodity Credit Corporation guarantees to finance LDC trade, thus enabling them to import essential goods. The Eximbank has provided expanded packages of guarantees for both Brazil and Mexico. We have also supported the use of bridge financing, increased resources for IMF loan programs, and the reduction of barriers to foreign investment in these countries. Above all, however, the recovery of these countries depends on their ability to export which in turn depends on their ability to obtain market access in the developed countries. In this regard, the Generalized System of Preferences (GSP) program affords preferential access to LDC exports and assists them in earning the foreign exchange needed to honor their debt obligations. The

extension of this critical program which is pending before this Committee represents a lifeline to many of the developing countries of the world.

The foreign exchange value of the dollar is also a key matter of concern. Since 1978, to the beginning of this year, the dollar rose 14 percent against the yen, 27 percent against the German mark and 69 percent against the French franc. In effective terms the dollar rose by 40 percent. As a result, otherwise competitive U.S. producers are being priced out of our own as well as foreign markets by a dollar that has experienced an exceptional increase in a very short period of time.

The factors determining the dollar's value are numerous and complex. It is clear, however, that the dollar's current value is being supported by substantial movements of foreign capital into U.S. markets. Foreign investors buy dollars with foreign currencies in order to invest here; this has the effect of bidding up the value of the dollar in foreign exchange markets and reducing U.S. price competitiveness in trade.

There are several considerations behind the large capital inflows supporting the dollar. We are the world's most prosperous and stable economy. And thus the dollar has become the world's hedge in periods of crisis—and there have been many. In a more geographic sense, capital in flight from politically volatile regions of the world finds safe haven in the United States. Our vigorous recovery and expansion as well as our open investment policy have also attracted foreign investors. And, the fact that real interest rates in the United States are well above those in most other countries has stimulated the inflow of short-term foreign capital in search of maximum return.

Foreign investors could decide for a number of reasons to reduce the flow of their investments to the United States which would lead to an easing of the dollar and some improvement in trade. In fact there has been some tendency since the beginning of the year toward a depreciation of the dollar's value. Policy choices to sustain this movement are limited, however. There is nothing we can or should do to reduce the safe haven aspect of our economy, other than to pray that other nations will find the peace we so enjoy. Nor do I question the desirability of open investment policies. This leaves the problem of high real interest rates.

Our high interest rates in part result from the fact that our current national saving is inadequate to finance both Federal deficits and the private credit requirements of an expanding economy. Recent surpluses in state and local government accounts have helped limit the gap between national saving and national investment. A gap, however, still remains and is being made up in a financial sense by capital inflows from abroad. Last year net foreign investment in the United States amounted to $35 billion, or about 7½ percent of private domestic investment. Capital inflows, however, were on an increasing trend during the year, reaching an annual rate of $58 billion by the fourth quarter or 11 percent of private domestic investment. Relatively high interest rates are a condition for attracting this foreign capital. Our financial borrowing from abroad manifests itself in a real sense by importing more goods and services than we export. We cannot have both a sustained economic expansion at home and a more competitively valued dollar for trade purposes unless we are able to substitute increased domestic savings for foreign credit.

The exact relation between the size of the Federal deficit and interest rates is subject to considerable debate; however, few would argue that government borrowing to finance increasingly large deficits reduces interest rates, or is even completely neutral with respect to rates. Reductions in future Federal deficits are essential to our long-term domestic economic health, and they are essential to any improvement in our trade account.

The unprecedented size of our trade deficit has raised questions in the minds of many about our competitiveness. While it is clear that the high value of the dollar has seriously eroded the price competitiveness of many U.S. producers, there has been a tendency to overstate the extent of our competitive problem.

U.S. competitiveness in world markets in the long term depends on the performance of our domestic economy in areas such as technical and product innovation, adoption of advanced plant and equipment, investment in education and human skills, and a healthy rate of output and productivity growth.

Our economy performed better during much of the 1970s than is often realized with real per capita income rising an average of 2 percent a year, faster than the 1950s rate of 1.4 percent and only somewhat less rapidly than the 1960s rate of 2.6 percent. Our productivity performance, however, did falter as the staggering increase in oil prices rendered a good deal of U.S. capital equipment obsolete and as employment swelled by 20 million to accommodate the rapidly growing labor force of the 1970s. I might add that the economic problems of spiraling inflation and strained capital resources accumulated by the end of the 1970s and created a

somber outlook for the future of the economy at that time. Through incentives to capital investment like the acceleration of depreciation allowances, through reductions in regulatory burdens and taxation, and through success in bringing down inflation, the basis has been laid in the last three years for sustained non-inflationary growth and solid gains in both productivity and employment, which rose by 700,000 last month and by close to 5 million since the recession's end.

The slackening productivity growth in the 1970s may have contributed to U.S. loss of world trade market share in the last decade. The U.S. share of world manufacturers exports was 16.4 percent in 1980, down from 18.4 percent in 1970. Our share did, however, recover somewhat to 18.1 percent in 1981 and 17.3 percent in 1982.

The evidence does not suggest that we are deindustrializing. Since 1970 industrial production in the U.S. has risen by 41 percent, more than Canada's 37 percent, France's 32 percent, Italy's 23 percent, Germany's 20 percent or Britain's 12 percent, although not as rapidly as Japan's 57 percent. Even since 1980 when the dollar began to rise, the index for manufacturing production has risen 6 percent and is still rising steadily. Whatever the impact of the domestic determinants of our long-term competitiveness such as innovation, investment and productivity, they certainly have not led to U.S. deindustrialization.

The unprecedented size of our trade deficit is to a large extent the result of U.S. and world macroeconomic factors such as the strong U.S. recovery in advance of the rest of the world economy, LDC external debt and the inadequate level of U.S. net savings. I do not believe that our trade deficit reflects any broad based decline in our fundamental industrial competitiveness. This is not to say that a weakened dollar would spare every U.S. industry from structural adjustment pressures from competitive imports. To deal with such industry specific situations, however, we do have trade laws which we have used and will continue to apply. But I do not believe that the traditional industry-specific tools of trade policy are particularly appropriate or effective for substantially reducing the current deficit.

There are, of course, serious problems of market access for our exporters in foreign countries. We are vigorously seeking the reduction of barriers to our important agricultural exports as well as to manufactured goods. In addition, the Administration has been exceptionally active in enforcing U.S. trade law to protect the interests of U.S. firms and workers when injured by unfair foreign trade practices. These efforts will continue. But we must also understand that the growing size of the U.S. trade deficit is for the most part not directly caused by either U.S. trade policy or foreign trade practices. If we are to successfully respond to the problem of the trade deficit, we must deal with its underlying causes found in the forces shaping our overall balance-of-payments position and the exceptional value of the dollar.

While there are provisions in our trade law to deal with macroeconomic aspects of our trade problems, we have to be sure that their use is not counter-productive. In fact attempts to employ trade policy to reduce the current deficit may actually backfire and worsen rather than improve our situation. Such, I believe, would be the case with respect to action under Section 122 of the Trade Act of 1974 to impose an across-the-board import surcharge. Such a surcharge would not just tend to reduce imports, it would also tend to strengthen the dollar or moderate its decline. The dollar's value is determined each day in foreign exchange markets by conditions of supply and demand. Limiting imports, also limits the supply of dollars in foreign exchange markets thus appreciating its value.

Under a flexible exchange rate the principal indication of an incipient balance-of-payments deficit is a tendency for the dollar to fall in value. Section 122 provides for the imposition of an import surcharge precisely to prevent an imminent and significant depreciation of the dollar. It makes little sense to impose a surcharge when the best hope for improvement of our trade balance is just such a moderation in the dollar's exchange value. The result of a surcharge then could be to further strengthen the dollar and reduce the ability of U.S. exporters to sell abroad. We could very well drive down both U.S. imports and exports while obtaining very little improvement in our trade balance.

What then should we do to improve the difficult situation of our foreign trade deficit?

First, I think we must face the uncomfortable fact that even though our exports are beginning to grow again, our trade deficit will increase further before it begins to improve. Even a rapid and substantial deterioration of the dollar would require 12 to 18 months to have sizeable effect on the U.S. trade balance.

Second, actions to reduce Federal spending and deficits as well as measures that increase domestic savings are highly desirable from the point of view of foreign

trade. The cost of growth should not be a high dollar; the less we need to borrow from abroad, the stronger our overall trade performance can be.

Third, we must resist demands for protection warranted only by competitive pressures from the overall deficit. Such protectionism for some sectors would be at the expense of other U.S. workers and producers. It would create economic distortions here at home reducing our ability to accomplish necessary economic adjustments to a changing world economy while contributing little to the solution of our trade problems.

Fourth, we should recognize that time will work in our favor internationally. Further recovery abroad will improve demand for our exports; the movement of our domestic economy to a sustainable long-term growth path will moderate the recent torrid growth of U.S. demand for imports.

Fifth, we must continue to strictly enforce our trade laws so that U.S. firms already suffering from strong foreign competition are not forced to face the added burden of competing against foreign governments. We must be able to ensure that Americans are not unfairly deprived of their jobs by foreign government intervention. We are aware that other nations have been critical of some of the trade actions taken by the United States. But let us all understand the distinction: there are cases when certain actions are not only acceptable, but are ethically and legally right. These actions, taken in accordance with U.S. law and international law, must not be confused with protectionism.

Lastly, we must continue to work with our trading partners to ensure the expansion and liberalization of world trade in the years ahead.

I thank you for this opportunity to present my views on the problem of the trade deficit.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. Mr. Ambassador, the talk nowadays is "adjustment," which refers to how these nations adjust to changing world economic conditions. All of them have been going through a very painful industrial readjustment. But I look at a nation like Japan, who apparently does not adjust insofar as agriculture; I look at a nation like our own, where we have reduced the people who live on the farm to where they are only 3 percent of our total population; and then I look at the European Common Market, where they have their subsidies so high, they have not only become self-sufficient on agriculture but now they are very major exporters of substantial subsidized agricultural products.

Where does it stop? How do you turn that around? How do you use bargaining power, your limited bargaining power, to try to change that kind of equation? I haven't seen much headway made.

I saw the situation where we fired a shot across the EC's bow when we subsidized a wheat flour sale to Egypt, and I really thought that was meaningful; but it turned out to be just a blip, an aberration.

I think that you have to be tough and have to do a number of those things in series in order to make foreign governments understand our concerns before we have some meaningful headway. And I am not talking about just the European Common Market, but I am talking about tactics and trying to make headway.

Ambassador BROCK. Well, first of all, I think that was a good step and it did do us some good. The problem that we have had in the last 6 months in this particular case with the European Community is that their own budget is putting more pressure on them than all the Egyptian wheat sales we could have, and it costs us a whole lot less money to let their budget reality work its way through the political system so that they take the steps that we think are necessary for trade, but they do it for their own interest. And that's happening.

If you will look at the action within the last week in Europe, there has really been a remarkable change in the dairy program, where the largest amount of money is being spent in terms of subsidy.

I don't believe we are anywhere near close to nirvana at all, and I don't want to leave that impression, but I do think that economic reality has a way of intruding even on politics on occasion. It is doing it here with our deficit, it is doing it there with their deficits, in trade as well as in the budgetary sense, and I think if we are very careful and work with them to develop an alternative system which would allow for trade and agriculture to proceed, I think we can make some progress, and I think it does not have to be a long-term process; I think some time in the next 12 or 15 months a great deal of progress can be made.

The problem is really political, not economic. You and I both know that there is not enough trade involved in the Japanese quotas to warrant a shotgun, but the problem is symbolic.

Senator BENTSEN. But I turn around and look at what they do on main frame computers, I look at what they do on the Nippon Telephone and Telegraph to exclude our high tech exports. Those things are meaningful and substantial.

Ambassador BROCK. I accept that, but let me point out to you that, as I testified before this committee a few weeks ago, the agreement we have now reached on NTT with the Japanese is a substantially improved agreement, and it is an agreement now that is supported by every American business that is involved in trying to sell to Japan. They believe that we have a good agreement, that they have a prospect now of real market growth, and that they can sell some goods over there.

Senator BENTSEN. Mr. Ambassador, I hope it works out that way.

Ambassador BROCK. So do I.

The CHAIRMAN. Senator Heinz?

Senator HEINZ. No questions, Mr. Chairman.

The CHAIRMAN. Senator Mitchell?

Senator MITCHELL. Thank you, Mr. Chairman.

Mr. Ambassador, the rise in the trade deficit that is to some extent concentrated in the manufacturing sector—some analysts attribute this to factors that may be temporary and hopefully self-correcting such as the high value of the dollar and our recovery. Do you agree with this analysis? Or do you think there has been a more fundamental deterioration in the competitiveness of U.S. business?

Ambassador BROCK. If you talk about business generally, we are relatively more competitive than we were 10 or 15 years ago with regard to most of the world. If you talk about specific industries, then you can look at some of the problem areas.

The biggest single product coming from Japan in terms of that $20 billion deficit we have with them is automobiles—1.68 million units a year. We got out of competitive line in that industry, as we frankly did in steel over a period of years, for a variety of reasons. I don't put it all on labor, I don't put it all on management, I don't put it all on Government; all of us have had a role to play in the problem. And with that, circumstance does not apply, in most

American industry. And where it does apply, we simply have to turn it around and get competitive again.

You can't say that the United States is disindustrialized and you cannot say by any documentary evidence that we are in a less competitive circumstance. As a matter of fact, we are in a remarkably good competitive circumstance.

You can quantify the trade swings. The $20 billion, precisely, in Latin American trade is a swing from a $6 billion surplus to a $14 billion deficit, almost exclusively because of the debt problem. The swings in imports and exports—you can take from a too-weak dollar in 1978 to a remarkably strong dollar in 1984 and say somewhere in between the figures would have been a good deal more healthy. But you can't put it down to a lack of productivity. You can't put it down to a lack of effort or a lack of initiative, of innovation, of investment in this country. You can say that if we don't change some things we are going to have a problem in the future. You can say—as Senator Bentsen mentioned, the word "adjustment," as did Senator Heinz—that unless we come to grips with that word more effectively, we are going to have problems in the future; unless we deal with these skill-training programs and with the rate of savings in this country, we are going to have trouble. But you can't put those down as the cause of our difficulty now.

Senator MITCHELL. Someone commented earlier on the inflow of foreign capital. That of course has had the desirable effect of financing the budget deficit and therefore reducing the so-called crowding-out effect which we may be now seeing beginning to occur.

Ambassador BROCK. Yes.

Senator MITCHELL. Unfortunately, that inflow has also raised the value of the dollar and affected our competitiveness in the international economy.

Ambassador BROCK. That's right.

Senator MITCHELL. I am very much concerned about our continuing reliance on foreign capital to finance the deficit. We could end up with the worst of both worlds. If that inflow slows down and the future deficits remain high, the crowding-out effect will be felt.

I would like your thoughts on this, and what, if anything, you think we might do to change it. First and foremost, of course, is reducing the deficit, but I would like to hear what else you have to say on that.

Ambassador BROCK. The second is to increase the rate of savings. You are talking about a pool, a capital pool, that is a defined pool—a certain amount of money that we create by savings, by profits, by depreciation in this country each year, the improvement in our cash-flow.

Now, to the extent that that capital pool is subsumed as it is today, totally—totally—by the Federal deficit, all of it, that leaves nothing for the private sector. The private sector, to get money, has to pull it from one of two sources today: either from foreign investment or from the savings, excessive savings, or "surpluses" if you want to use the word, of State and local governments, where we have had a surplus for the last couple of years.

The State and local governments amounts to about 1 percent of GNP, and about 1.5 percent is coming from overseas.

Here's what is going to happen, Senator: If we start losing that money for overseas, the pressure on the interest rates is going to go up, and the interest rates will go up enough to pull more money in it from overseas. We'll finance our deficit—there is no question about that; we can do that. What will happen though in the process is that by pushing your interest rates up, you then will deprive the domestic business of the chance to make investments in growth, and you are going to have an economic recession. Now, I think that's the hazard you face until you come to grips with this fundamental problem. You either have got to reduce the Federal drain in the form of deficits, or you have to to increase the size of that pool by increasing savings and profits. It's one or the other—or both, hopefully.

Senator MITCHELL. My time is up, but I would just ask, briefly: So, you don't agree with the Secretary of the Treasury when he says that the high budget deficits don't have any effect on the interest rates? You ought to be able to answer that one yes or no.

Ambassador Brock. Yes or no. [Laughter.]

I think it is fair to state that the short-term impact is marginal. I don't think it is possible to argue that the long-term effect is negative.

Senator MITCHELL. That is one of the better yes or no answers I have heard in a long time. [Laughter.]

The CHAIRMAN. Senator Long?

Senator LONG. Mr. Secretary, I enjoyed reading your statement—your full statement—which includes the wise remarks of the previous-Senator Brock who voted against the Smoot-Hawley Act. I followed a Senator 2 years later who was also opposed to the Smoot-Hawley Act because he was trying to build highways in Louisiana at the time, and that raised the cost of cement. That was his principal objection. I am sure he could have found some more, if he needed to.

But we are in a new day now. When I became a member of this committee and began to look at the effective trade balance, and it wasn't always what we would like for it to be, but I was assured that we didn't need to worry about that too much because the American holdings overseas were so much greater than what foreigners held over here that we could run a deficit for a very long time and we'd still be in reasonably good shape.

But as you know, that is changing now. At the rate this change is going, it will only be another year or two before we will be a debtor nation. And here we are, the richest Nation on the face of the Earth, virtually a debtor—our Nation, that has been urging all these poor nations to use American capital to try to build their own economies.

You and I don't think that's right. We don't think it is a good idea; it's not good for our country and it's not good for them.

In my judgment, we really are going to have to turn some of these policies around and do some things that we haven't been talking about doing up here. And until we do, this isn't going to work.

Now, I know you are a good negotiator. You have done a good job in working for this Nation's interests and trying to make the best deal that could be made. But let me just tell you, from a person

who has been watching this thing for a long time, you can't negotiate these big deficits away, because our deficit is the other guy's profit. And a country like Japan likes it that way. They brought the Prime Minister over here—bless his heart—and he tried to go the extra mile to work out something with President Reagan. I wasn't there, but I read reports of what was said and I think the Prime Minister in good faith tried to go as far as he could to try to work the problem out involving our two countries. What happened? He went back home and they practically impeached him. Now, what little that fellow could do in that respect and still survive politically was only a drop in the bucket to what it would take to put our affairs with Japan to where they ought to be.

Now, just in terms of how we ought to be treating trade policy in an ideal world, in view of the fact that there is nothing they are producing over there that we can't produce here, shouldn't we have a balance of trade, about an even balance of trade with Japan? In the absence of something to dictate otherwise, shouldn't we have a balance of accounts with them? About an even-trade deal?

Ambassador BROCK. Sure. But to do that, Senator, does not mean we should limit them so much as that we should sell more or get more competitive.

The biggest single element in that deficit is in one product. And I think our own manufacturers, our own labor unions, will tell you that our product costs another $1,500 per car, maybe $2,000, over what it costs to produce it in Japan. Until we produce a competitive product, you are going to have a deficit.

Senator LONG. Now, let me just put on the record what I have told you privately about this matter:

Our tax system is part of the problem. You can lay it right on this committee if you want to—you have served here; you are familiar with that.

Ambassador BROCK. I've got to accept part of it, yes.

Senator LONG. The way I analyze it, the difference in taxes between their system and ours ought to account for about 14 points out of 100, in the retail price where they are taxing mainly impacts on their consumers. And by the rules we are playing the game by, they can rebate that on their exports. Our taxes are not rebated. The Social Security taxes, the income taxes, the State and local taxes—no credit for that. And there is no barter tax as they have when the products enter their market. That's just like a 14-point advantage.

This currency differential has varied from 20 to 40 points, so let's just average it out at 30 points, just to pick a figure. That means that foreign exporters are selling that product at a 30-percent discount in our market. Now, you add those two together and that's 44 points. All right now, subtract the cost of insurance and freight, let's say that's 10 points, and that gets you down to about 34 points.

Now, even if our workers were settling for the same wage that the Japanese are settling for, the Japanese would still have an advantage of 34 percent, after they pay the freight and insurance to put the product into our market.

Now, it seems to me that we can talk about labor not being productive—"Aw, yeah, their a lazy lot, they are featherbedding, they

are sitting around scratching themselves when they ought to be turning to and moving these things around that production line"—we can say all of that we want to, but as a practical matter, if you assume that they are equal, they are getting the same productivity—and I had some people down my way say that they are getting about the same productivity in some of their plants that the Japanese are getting—but assuming they are equal, we are still 34 points out of the ball game. And that deficit results from factors that those workers can't do anything about, and really items that management can't do anything about.

I really think they've got a right to look at us and say, "What's the matter with you people up there? We're getting all the worst of it, and you people should look after our interests for us."

Now, I don't think you are going to negotiate that away. The Japanese want to put those products into our market, and I don't blame them. But I find myself thinking in the terms Herman Talmadge used when he was in Japan many years ago. He was talking about how bad the trade picture was from our point of view with Japan, how unfavorable, and someone said, "Are you critical of the Japanese Government?" He said, "Not for 1 minute. I am not criticizing the Japanese Government for looking after their people; I'm criticizing our Government, that it doesn't do equally well by ours." And I think that that's the thing we ought to be looking at.

Now, I know something about your problem. I have been at some of these international meetings. They gang up on you. You are one poor soul up there, and they are 50. They shout you down, treat you like something the cat dragged in, call you a "dirty protectionist" and everything else because you try to speak up for your people.

But I should think that we have got to take a different approach to this thing, and we are going to have to do some things that we are not talking about doing to get this genie back inside the bottle.

Ambassador BROCK. Senator, I don't disagree with a lot of that. I guess the point is, what do we do? There are plants here that are as productive as there are in Japan. But unfortunately, they are Japanese plants. [Laughter.]

Now, in Ohio you have got a good——

Senator LONG. We have one in Shreveport, LA, that would give them a good run for their money.

Ambassador BROCK. You do.

Senator LONG. And that's not a Japanese plant; it's a General Motors plant.

Ambassador BROCK. But if you take the real advanced areas, we are competitive.

You know, something else my grandfather used to say that made sense to me is, there is a limit to how hard somebody can work. You've got to make them worth more, not just work more. And that's a pretty good way to put it.

But if you don't have in this system of ours an ability to invest enough to give those workers the tools—the robotics, the machine tools—to be productive, then you are not going to be competitive. And in the late 1970's we did hit those people with every kind of policy we could hit them with—tax policy, environmental policy. We put the whole burden of a lot of our social changes on corpo-

rate systems; not just automobiles but steel companies were being told, "You've got to clean up the whole environment. You pay for it. We don't want to pay for it."

Well now, you can't do that and then tell those same companies, those same workers, "You've got to go out and compete with somebody that doesn't have to do that." That's part of the problem, too. And I accept that, I really do; but I think you are right: I don't think you can put that at the doorstep of Tokyo. I think those answers have to come from here.

If we are going to look at a value added tax in Japan, the question is, we made a decision not to have one here, so I'm not sure we can criticize them for having it. We said, for our reasons, "We want an income tax. We don't want to tax consumption."

Senator LONG. Well now, let me just touch on that point for a moment. At the time, you will agree that the GATT was negotiated we were the rich guy on the block.

Ambassador BROCK. That's right.

Senator LONG. We could afford to do all these things. Europe was down, they sadly needed some help, and we could afford to be the generous fellow and give them all the advantages. And we can no longer afford to do that.

Now, I have explored this matter about taxes enough to know that it is strictly within our rights, even if you want to comply with every letter of the GATT agreement, it's strictly within our rights to pattern our tax system after theirs. I think we could even go beyond that: I think we would have the right, if we wanted to, to simply levy a direct tax of some kind, either a manufacturer's excise tax or a value added tax, and to give our manufacturers a credit against that tax for all the taxes, State and local, that they are paying in other respects in the United States. I'm inclined to think we have the right to do that. And I see you nodding; you might agree with that.

Ambassador BROCK. Yes.

Senator LONG. Incidentally, I mentioned that to some outstanding American companies recently. They were very enthusiastic about the idea. Now, of course, it has some wrinkles that some wouldn't like—for example, in an inefficient company they are paying very little income tax; they would have to pay more taxes.

Ambassador BROCK. Right.

Senator LONG. But the efficient companies would be tickled to death with an arrangement like that.

So there are things that we have it within our power to do to neutralize that differential. And it would seem to me that if we want to do it, we also have it within our power to neutralize that currency differential. For example, if anybody is holding his breath until we have a balanced budget, for God's sake, start breathing again. You aren't going to survive. [Laughter.]

It's just not going to happen.

And I voted for a balanced budget. May I say that, if it had carried, it would have had some political repercussions, that won't occur because it didn't carry, because it would have required some very severe cutbacks in various places.

But I am willing to vote for taxes and vote for spending cuts, and voted for the bill reported out here. I will even offer an amendment

out there to try to do more, about putting more taxes on and cutting spending further. But there is not going to be any balanced budget anytime soon, so that problem will remain.

The same thing is going to be the case about some of the other problems.

Some of this money flowing into the United States is illegal. I keep reading about these people, a person who was indicted down there the other day—I see him every day over at the Watergate apartment building, for allegedly helping to launder some of that money that had to do with narcotics. So it looks like the international dope trade wants to bring their money in here, thinking it is a good place to keep it, and that it's safer here than it would be somewhere else. [Laughter.]

And people get scared over there in Europe, so they want to anchor to windward, they put their money over here in the United States. People in Latin America are afraid that the Communists are going to take over, so they start moving their money in here.

But it's not fair to penalize American workers or American industry because of it. We don't penalize the old people on social security because of it; we don't penalize our Federal workers because of it—they get an annual adjustment keyed to the cost of living. And it seems to me that we owe it to our own industries and to our workers who are paying for all of this to take a look at their problem and try to do something about it, or at least consider doing something about it, which so far we have had very little discussion about—what can we do to put them on the same basis as those with whom they are competing?

Now, I am also concerned—I might mention one other item—about the fact that these OPEC countries have joined together in a practice that from the trade point of view is little short of piracy, and you agree with that, to make us pay a price far beyond what we think it ought to be to buy oil on the world markets.

Ambassador BROCK. Absolutely.

Senator LONG. You agree with that.

Now, having done that, just read the books that are being written by the folks who are advising them what to do. They say, "All right, now having priced the raw material very high, we will now use it to make products that are very low-priced, and we will sell those products for what ever price it takes in order to invade foreign markets, including the United States market."

So next we are told, "Well now, if you are going to buy our oil or our gas, you've got to buy the more advanced—chemical products—next."

So first they start by making us pay 10 times the price for the natural resource, then they tell us they are now going to insist on the right to invade our markets and put our chemical industry out of business.

Now we are competing with the Mexicans down there. We have our poor souls out there trying to make a living catching shrimp; but we are going to have to go out of that business, I suppose, because they sell their gasoline so much cheaper than we sell gasoline, to their fishing boats.

Then, if you think you are in good shape just because you are manufacturing a finished product—garden hoses and things like

that—let me tell you, you are going to have to buy imported garden hose in order to get that material.

Now, if we don't do something about that, Mr. Ambassador, we are going to lose just lots and lots of jobs. And obviously, you're not going to be very popular if we can't turn this thing around. That's why I am calling on you to do some thinking and suggest to us some things that we can do about it—not just put sand in our eyes. Every time I try to do something about a problem, there are so many people who explain why my idea won't work. Well, I'm going to find out. If that won't work, you tell me of something you think will work. But we need help, to help us to compete. We are not seeking any advantage; we just want the opportunity to survive and compete with others on a fair basis.

Ambassador BROCK. I don't disagree with that, Senator. And I think the point about these subsidies—upstream, downstream, whatever you want to call them—is a legitimate point. I would be happy to sit down with you and try. We haven't got a good answer for that one yet.

Senator LONG. Here's how they tell me Mexico is pricing those chemicals coming into our country: They do it backward. They start out by first taking the selling cost.

Ambassador BROCK. That's right.

Senator LONG. Then they take the delivery cost. Then they take the cost in the plant and the labor cost, and the last thing they put in there is the raw material, the oil or gas which is 70 percent of the cost, and they will put that in at zero if need be so they can sell the product in our market at what appears to be a profit.

Ambassador BROCK. Yes.

Senator LONG. Now, if those workers in our plants were working for zero, they still couldn't offset a 70-percent advantage in the raw material that goes into it. I just think that we ought to be looking at these things and coming up with some better answers than we have had so far.

I want Mexico to do well. But I don't think they have to do well by crucifying American people who are working for a living, legitimately, and doing a good job.

Now, I have yet to hear anybody who thinks our chemical workers down there are not doing a good job; those are very good hard-working workers.

Ambassador BROCK. Yes; I don't disagree with that. And we have been having some conversations, and we will have some more, on how to modify our law to be sure that we do not get put into that kind of a situation. And I would be happy to sit with you on that kind of a discussion.

Senator LONG. You know, my impression as a politician, as a fellow who has to run for office occasionally, is that if I'm in the beginning of a 6-year term and somebody comes to me with a problem, I might take the attitude, "Well, if it's for the benefit of the world community and all concerned, you know, it's better just to do nothing about the matter." But when I've got about a year or two to go before I face the electorate out there at the polls, I find myself thinking, "Well, it's my job as well as his that's involved here, and I'd better get something done about this thing." [Laughter.]

And I'll be thinking more in those terms, Mr. Ambassador. I wish you well; I think you are doing the best you can with a difficult problem. But I think that we ought to be working as a team a lot more than we have in the past, just because of the facts that I showed.

We should not be borrowing money from the poor nations all over the Earth in order to keep our economy operating, and to some extent, that is what we are doing.

Ambassador BROCK. I agree with that.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. No questions.

The CHAIRMAN. Senator Boren.

Senator BOREN. Just very briefly, Mr. Chairman.

If we continue the present projected imbalance in trade, at what point in time do you estimate that we would become a debtor nation? On the trend line under which we are now operating, when would this country become a debtor nation if we don't reverse the trend?

Ambassador BROCK. Probably some time in 2 to 4 years.

Senator BOREN. What dangers would that create for us?

Ambassador BROCK. Well, it raises the price of doing business. The first thing it does is, by pulling in so much money from overseas, you do reduce their economic growth there. And one of our great opportunities for growth is in the markets we have overseas. If they don't get good growth, then we don't have that market opportunity. So that's No. 1 in terms of hazard.

No. 2, you are going to put great pressure on U.S. businesses to move out of the United States and to locate their plants elsewhere. Now, previously it was made on a pretty rational economic basis; but if there is a view that this thing is going to continue for a long time, then business will start making long-term investment decisions on the basis of where to locate their plants, and they won't be here, because it will be cheaper to make it over there and sell it here than it will be to produce it here. And that's a second hazard which does begin to lead us to the disindustrialization.

The third factor is the element of the dollar itself and what that will do to our competitive circumstance, both in exports and in imports. It will tend to push the dollar higher than it is.

Senator BOREN. Recently I was in a meeting where I heard it argued that there are economic studies underway which demonstrate that the real cost of capital in this country is much higher than it is in many of the other nations with which we are competing.

Ambassador BROCK. The real cost of equity capital, in the estimate of a number of people including me, is around 20 percent in this country right now.

Senator BOREN. And according to these studies, that is double or triple the real cost of capital in other countries with which we are competing.

Ambassador BROCK. Yes.

Senator BOREN. If that situation continues in the long run, it is quite obvious that if we are going to keep the prices of our products competitive when the cost of our capital is that much higher, then the only way to do it would be to drastically reduce the real wages

of American workers. It would have a devastating impact on the real standard of living, of our people, if we are not able to reverse that. Wouldn't that be true?

Ambassador BROCK. Sure, because there are only two elements in production: One is capital, and the other is human capital—financial capital and human capital. Your financial capital gives you the tools. If your financial capital is priced up here, you don't give your workers tools And if they don't have the tools, they can't earn the money.

Senator BOREN. So the only choice if we are going to remain competitive with price, would be to lower the wage by a devastating amount. To avoid that course we must reduce the cost of capital.

I suppose that there are several factors which go into the real cost of capital. The long-term interest rate has to be one of those factors, and that's very much affected by the deficits which we are now having. The tax structure, the way we now have it, is much more aimed at income as opposed to consumption, and the balance of the present tax structure contributes to high capital costs.

I wonder if your Department has been carefully looking at these studies, or perhaps developing studies of your own? What suggestions could you make to the committee as to changes we could make? As Senator Long said, we really need suggestions: How much more do we need to lower the deficit beyond the proposals which have been made, in order to return stability to long-term interest rates? What specific changes do we need to make in the tax system?

I am intrigued by Senator Long's idea of giving companies an option, of whether to go with the income tax, the present income tax structure, or go to the excise or value-added tax rate which could certainly be rebated if we were in the export market.

I am alarmed by what you say will happen in the next 2 to 4 years if we don't turn this thing around. When can we expect from the administration some very aggressive recommendations, both in terms of further deficit reductions and in terms of suggested changes in the tax structure, and any other changes that might be advisable, to get back again a competitive position in regard to the cost of capital?

Ambassador BROCK. Senator, I think the answer comes in two stages: First of all, I don't believe that any of us felt that we could have a major look, a constructive look, at the tax system in 1984. It is just too frenzied a year, and it would be very difficult. This is going to be a tough debate, and it is going to require a lot of energy—intellectual and emotional—to see anything as important as a fundamental reshaping of the tax system done. I think most people felt like we had to begin that early in 1985. The research has begun, but it isn't anywhere near completed on the more equitable and efficient tax system.

I know that a lot of Members in this body, some of the members of this committee, have introduced bills of that sort. So there is a lot of thought going on. But I don't believe that any of us felt we could get it done this year. And we thought, frankly, that we would have to take it up in 1985.

Senator BOREN. Well, I would just urge you to proceed with it.

You know, we talk often in terms of an industrial policy for this country. Often, what is meant by that is something I can't really foresee, some very artificial structure, bringing labor and management and government all together in some commission which I don't think will work given our free economic system. But it does seem to me that for labor, here is an area where there is a shared self-interest. If our cost of capital remains completely out of line competitively, it is not only the management of business that has a very direct stake in this; it's all labor, including organized labor which also has a tremendous stake in it.

It seems to me that if we would just really begin to focus upon this, that we should be able to get a broadbased support for some of the changes which need to be made.

Ambassador BROCK. Well, I think we can. And frankly, I want to pay some compliments. I think the actions of this committee and the Ways and Means Committee in the House indicate a pretty sincere desire to move in that direction.

There are things happening. We are beginning to talk seriously about significant reductions in the deficit right now. And that to me is the most hopeful sign of all, because the people don't expect us, as Senator Long said, to eliminate the deficit; but they do expect us to make a commitment to pulling it down over a period of time. If that commitment is made, you are going to see interest rates come down. If it's not, you are going to see them going up.

Senator BOREN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Ambassador, I do have some questions that I will submit in writing, but we have a number of other witnesses.

I wanted just to make one point. You indicated that the less developed countries, particularly in Latin America, have been a major reason for the deterioration of the U.S. trade balance. I guess my question would be: Do you think it is appropriate to impose a greater share of the burden on the banks that extended these credits, thereby lessening the burden now borne by American exporters in import-sensitive sectors?

I might add to that, I have asked the staff and Treasury and the Joint Committee to take a look at how banks are able to charge off their losses, where we in effect end up assuming part of those losses because of credit that was extended without much regard to whether or not they are ever going to be repaid.

Ambassador BROCK. It is pretty tempting, Senator, but I guess I would like to look at it before I respond, because I really don't know how in fact it might finally work. I don't want us to take an action like that that would do more damage than it helps.

The CHAIRMAN. We are not suggesting that, but we are suggesting that at least we ought to take a look at it.

Ambassador BROCK. Yes.

The CHAIRMAN. Maybe they would be a little less anxious to extend credit, to loan money. But we are looking at just the tax consequences, whether or not there is anything that should be done. Maybe we will determine nothing should be done.

I do have some additional questions, which I will submit in writing. We appreciate very much your coming here, your private visit as well as your statement this morning. Thank you very much.

Ambassador BROCK. Thank you.

The CHAIRMAN. While Marty is coming up, I would like to ask the committee just to switch gears for a moment.

The Child Support Enforcement Act was marked up yesterday, H.R. 4325. We are now in a position to report that bill. Two amendments that were in doubt have now been defeated, which will reduce the additional cost by a couple or $300 million. So that would leave the amendment of Senator Long on the incentive payments, the amendment of Senator Grassley on offsets, and two or three other amendments that are not cost items.

I understand from Senator Long that he has no objection if we could poll that out, if we could get it to the floor.

Did I correctly state that, Rod?

Mr. DEARMENT. That's correct, Senator.

The CHAIRMAN. All right. So let's just, without objection, poll out the bill, so we can have it on the floor.

Mr. DEARMENT. On H.R. 4325 as amended, we would order it favorably reported.

The CHAIRMAN. Right. I am not certain anybody wants any additional views, but you can check with the members.

All right.

Marty, we are prepared to hear you. We know you must be pleased that this committee did—last Wednesday was it? I can't remember the date—by a vote of 20 to 0 report out a deficit reduction package which included about $25 billion on the spending side and $48 billion on the tax side, which is about half of the total package that the President has talked about. I know the Democrats now have a little larger package, but I would doubt that much will ever come of that, because I think we in this committee on both sides found out how difficult it was to raise taxes with the restraints we had—$48 billion over 3 years.

So, that may not be the thrust of your testimony; but as someone who has been concerned about the deficits for some time, properly concerned I would add, we are very pleased to have you here. And you may summarize your statement. We may have some questions.

Dr. FELDSTEIN. Fine. Thank you very much.

STATEMENT OF DR. MARTIN FELDSTEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Dr. FELDSTEIN. I am very pleased about the progress that has been made in the last couple of weeks in dealing with the deficit. I think we are moving closer and closer to resolving the need to do something this year, and I am very pleased.

But that is not the focus of my remarks today; they are instead about the dollar exchange rate and our trade imbalance.

I also wanted to respond to the committee's specific question about the appropriateness of invoking section 122 of the 1974 Trade Act to justify a rather radical change in trade policy.

I realize that in asking that question the committee wasn't indicating support for that idea, but I was frankly quite shocked to see that there was congressional interest in the possibility at this time of imposing a new discriminatory tariff against the products of a single country or a group of countries.

What I will do is summarize my longer statement by just reading and expanding on a couple of points in the first five pages of my submitted testimony. Then I would be delighted to answer questions.

Certainly, as Ambassador Brock said, the United States is experiencing a very substantial trade deficit, a merchandise trade deficit, that rose from $36 billion in 1982 to an expected amount of more than $100 billion this year. A trade deficit of that magnitude is certainly a problem for our exporters and for those American firms that compete with imports from abroad.

Although exports actually rose by about 5 percent during the first year of the recovery, the level of exports ended last year about 10 percent below the previous peak. By comparison, after a year of recovery in past economic recoveries, the level of exports had generally surpassed the previous peak. The reason for this difference is that, between the peak and the trough of the recession, we saw a very sharp fall in exports this time, a decline of about 15 percent. Although we are beginning to pull out of that hole, exports are very much below where they have been in the past.

An increased trade deficit does not represent any loss of fundamental competitiveness by American firms—a point that Ambassador Brock also emphasized. Part of the trade deficit is cyclical, reflecting the more advanced recovery here than in other major industrial nations. Another part of the current trade deficit is due to the reduced demand for imports by the LDC debtor nations.

But the major cause, as the Ambassador said, of this year's increased trade deficit—we estimate that it is somewhat more than half—is due to the rise in the value of the dollar that has occurred in the past few years. Indeed, the Treasury testimony that you will hear later provides a specific numerical decomposition of the $90-billion deterioration of trade exclusive of oil imports that has occurred between 1981 and 1984. Treasury estimates that about $20 billion of the $90 billion is cyclical, about $25 billion is due to the LDC debt problem, and the rest is due to the strengthening of the dollar. So about $45 billion is due to those first two factors, and the other $45 billion, roughly, to the stronger dollar.

Let me say also that this problem that the committee is focusing on, the trade deficit problem, will eventually correct itself even if there is no action. We don't need to change budget deficits or trade policy or anything else to correct it; it will correct itself. The rates of economic expansion in the United States and in other industrial countries will be closer this year than they were last year; the import capability of the debtor nations will also improve with time; and, in addition, the dollar will inevitably decline toward a level that is compatible with the approximate balance of our current account.

Although the speed with which the dollar will move toward a level that is compatible with such balance can't be anticipated with certainty, we have already seen a slight decline in the dollar in the past few weeks.

The reason that the dollar will inevitably decline is that if it didn't decline we would go on running these very large current-account deficits, the rest of the world would have to hold more and more and more American securities, and at a certain point they

would in effect say, "We've had enough." The only way we could get them to hold those larger securities would be at a lower level of the dollar, and when the dollar came down to a lower level then the trade deficit would shrink and vanish.

It is important, moreover, to recognize that there are advantages as well as disadvantages of the merchandise trade deficit under current conditions. The trade deficit entails a capital inflow that adds to the pool of investible funds in the United States. This year we expect an inflow of about $80 billion, enough to finance about half of all net fixed investment in the United States, or about 40 percent of the entire trade deficit. Note that I emphasize the word "net" capital inflow. What matters is the net flow, not how much comes in from abroad and how much we have put out to the rest of the world, a subject about which there has been some confusion, but the net difference between them—the net increase in the pool of funds available here.

A larger inflow is particularly helpful now, this year and in the next couple of years, because of the very large budget deficits, which are currently absorbing more than half of all net domestic savings. That is why I hesitate to use words like overvalued in describing the dollar today. It is clearly above the value that is sustainable, it is clearly above the value that balances trade; but if we didn't have the dollar at its current levels, we would have very different problems. Our exporters and importers would be better off, but the interest-sensitive domestic industries—the investment goods industries, the construction industry—would be much worse off.

That comment implies that reducing the trade balance by any type of trade intervention, including quotas and tariffs or policies to discourage foreign investors, would have adverse effects on our rate of domestic investment. Such effects would be particularly unfortunate when, as now, the net investment rate is so unusually low. It would be far better if the reduction in the trade deficit and the capital inflow accompanied a decline in the budget deficit. The reduction in the Government's demands for funds would then at least balance the reduced supply of funds from abroad. Moreover, a decline in expected budget deficits by reducing real interest rates would help to lower the dollar value.

There are other specific reasons for opposing the type of tariff that is contemplated by section 122 of the 1974 Trade Act. I am not a lawyer, but it seems to me that imposing a tariff on imports from a single country would be in violation of our treaty obligations under GATT. Such a discriminatory tariff would certainly run counter to the most-favored-nation concept that has been a fundamental principle of U.S. trade policy, and of the postwar liberalization of trade throughout the industrial world.

Furthermore, any tariff increase, whether focused on one country or more than one country, would run counter to all of our Nation's statements about the virtues of expanded world trade and the dangers of increased protectionism. The imposition of such a tariff by the United States could easily start a series of retaliatory actions that develop into a destructive trade war.

The immediate effect of a surcharge would be to penalize not only foreign producers but also American consumers. Prices of the

surcharged goods would rise, putting upward pressure on the overall price level.

On a more technical level, section 122 appears not even to apply to the current situation. The specific language of that section provides for the imposition of a tariff surcharge under two conditions: To deal with large and serious balance-of-payments deficits, and second, To prevent an immediate and significant depreciation of the dollar in foreign exchange markets.

Now, although we have a trade deficit and a current account deficit, we do not have a balance-of-payments deficit, in the strict sense envisioned in section 122. The technical definition for the balance-of-payments is the rate of accumulation of official reserve assets, including gold. Since net U.S. sales of other assets to foreigners, in other words net private investment in the United States, last year was more than enough to offset our current account deficit, the official U.S. reserves didn't have to be drawn upon. In fact, official U.S. reserve actually increased slightly last year. Thus, in a technical sense, I think the sense appropriate for interpreting section 122, the United States had a balance-of-payments surplus last year. We had a trade deficit, a current account deficit, but we had a balance-of-payments surplus in this official sense.

Thus, although the current account deficit will be larger in 1984 than it was last year, there is no reason at this time to expect that there will be a balance-of-payments deficit in 1984. We will have a trade deficit, we will have a current account deficit; but there is no reason to think that we will be drawing down U.S. reserves or selling off our gold stock, and therefore we don't have the balance-of-payments deficit that is required as a condition for triggering section 122.

It is clear, also, that the tariff surcharge cannot be justified to prevent an imminent and significant depreciation, to use the language of that act, of the dollar in the foreign exchange markets. The dollar is most likely to decline by a few percent during the remainder of 1984. Since the dollar is a volatile asset price, it is also possible that it could rise, or it could fall significantly; but there is no reason to believe that a significant depreciation is imminent. Moreover, under current conditions there is no reason to try to prevent such a decline.

The appropriate remedy for the present trade deficit is, as Ambassador Brock said, to reduce the deficit in the Federal budget. In saying so, I don't want to imply that the budget deficit is the sole cause of the trade deficit; but it would clearly be unwise to try to reduce the trade deficit by slowing our recovery or by weakening the dollar through inflationary monetary policy, or through statements aimed at undermining the political safe-haven character of the American economy.

By enacting the substantial deficit-reduction down payment package recently proposed by the administration and the Republican leadership here and in the House, it would be possible to move simultaneously to a more competitive dollar and to a lower cost of capital in the domestic economy.

I will submit the rest of this statement for the record, Mr. Chairman, and I will be happy to answer your questions.

[Dr. Feldstein's prepared statement follows:]

The Trade Balance: Is a Tariff Surcharge Appropriate?

Martin Feldstein*

Thank you, Mr. Chairman. It is always a pleasure to appear before this distinguished committee. I welcome this opportunity to comment on the problem of the dollar exchange rate and our trade imbalance.

I am, quite frankly, shocked by the Committee's interest in the possibility of imposing a new discriminatory tariff against the products of a single country. Such a tariff would run counter to the basic spirit of American trade policy and of our international treaty obligations. I will comment specifically on the Committee's question about the appropriateness of invoking Section 122 of the 1974 Trade Act to justify such a change in trade policy.

I will summarize my views briefly and submit a more complete statement for the record.

SUMMARY STATEMENT

1. The United States is experiencing a very substantial merchandise trade deficit. Our merchandise trade deficit rose from $36 billion in 1982 to more than $60 billion in 1983 and is expected to exceed $100 billion this year. A trade deficit of this magnitude represents a serious problem for American

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* Chairman, Council of Economic Advisers. This testimony was presented to the Senate Finance Committee on March 23, 1984.

exporters and for those American firms that compete with imports from abroad.

2. The increased trade deficit does not represent any loss of fundamental competitiveness by American firms. Part of the increased trade deficit is cyclical, reflecting the more advanced recovery in the United States than in other major industrial nations. Another part of the current trade deficit is due to the reduced demand for imports by the LDC debtor nations that can no longer finance their previous volume of imports. But the major cause of this year's increase in the trade deficit -- somewhat more than half -- is due to the 50 percent rise in the real value of the dollar that has occurred since 1980.

3. The trade deficit problem will eventually correct itself. The rates of economic expansion in the United States and in other industrial countries will be closer in 1984 than in 1983. The import capability of the debtor nations will also improve with time. And the dollar will decline toward a level that is compatible with the approximate balance of our current account. Although the speed with which the dollar will move toward this level cannot be anticipated with certainty, we have already seen a dollar decline of about 5 percent from its high earlier this year.

4. It is important to recognize that there are advantages as well as disadvantages of the merchandise trade deficit under current conditions. The trade deficit entails a capital

inflow that adds to the pool of investable funds in the United States. This year, the expected capital inflow of about $80 billion will be enough to finance about half of all net fixed investment in the United States. A large capital inflow is particularly helpful now because the budget deficit currently absorbs more than half of all net domestic saving.

5. The comment in the previous paragraph implies that reducing the trade imbalance by any type of trade intervention -- including quotas, tariffs, or policies to discourage foreign investors -- would have adverse effects on our rate of domestic investment. Such effects could be particularly unfortunate when, as now, the net investment rate is unusually low. It would be far better if the reduction in the trade deficit and capital inflow accompanied a decline in the budget deficit. The reduction in the government's demand for funds would then at least balance the reduced supply of funds from abroad.

6. There are other more specific reasons for opposing the type of tariff contemplated by Section 122 of the 1974 Trade Act. Although I am not a lawyer, it seems to me that imposing a tariff on imports from a single country would be in violation of our treaty obligations under GATT. Such a discriminatory tariff would certainly run counter to the "most favored nation" concept that has been a fundamental principle of U.S. trade policy and of the postwar liberalization of trade throughout the industrial world. Furthermore, any tariff increase, whether focused on one country or more than one

country, would run counter to all of our Nation's statements about the virtues of expanded world trade and the dangers of increased protectionism. The imposition of such a tariff by the United States could easily start a series of retaliatory actions that develop into a destructive trade war.

7. The immediate effect of a surcharge would be to penalize not only foreign producers but also American consumers. Prices of the surcharged goods would rise, putting upward pressure on the overall price level.

8. At a more technical level, Section 122 appears not even to apply to the current situation. The specific language of that section of the 1974 Trade Act provides for the imposition of a tariff surcharge "(1) to deal with large and serious balance-of-payments deficits" and "(2) to prevent an imminent and significant depreciation of the dollar in foreign exchange markets..."

Although we have a trade deficit and a current account deficit, we do not have a balance-of-payments deficit of the type envisioned in Section 122. The technical definition for the balance of payments is the rate of accumulation of official reserve assets. Since net U.S. sales of assets to foreigners in 1983 (i.e., the U.S. capital account surplus) is more than enough to offset the U.S. current account deficit, official U.S. reserves actually increased. Thus, the U.S. had a balance of payments surplus. Although the current account deficit will be larger in 1984 than it was in 1983, there is

no reason at this time to expect that there will be a balance-of-payments deficit in 1984.

It is clear also that a tariff surcharge cannot be justified to prevent an "imminent and significant depreciation" of the dollar in foreign exchange markets. The dollar is most likely to decline by a few percent during the remainder of 1984. Since the dollar is a volatile asset price, it is also possible that there will instead be either a rise in the value or a more significant decline. But there is no reason to believe that a significant depreciation is imminent. Moreover, under current conditions, there is no reason to try to prevent such a decline.

9. The appropriate remedy for the present trade deficit is to reduce the deficit in the Federal budget. In saying so, I do not wish to imply that the budget deficit is the sole cause of the trade deficit. But it would clearly be unwise to try to reduce the trade deficit by slowing our recovery or by weakening the dollar through inflationary monetary policy or through statements aimed at undermining the political "safe haven" character of the American economy. By enacting the substantial deficit reduction "downpayment" package recently proposed by the Administration and the Congressional Republican leadership, it should be possible to move simultaneously toward a more competitive dollar and lower cost of capital in the domestic economy.

SUPPLEMENTARY STATEMENT

The Rise of the Dollar

The exchange value of the dollar began to rise in the summer of 1980 and has increased nearly 50 percent beween 1980 and the current time relative to an appropriately weighted average of other currencies, after adjustment for differences in national inflation rates.

For example, $100 could be exchanged in 1980 for 182 German marks. At the end of 1983, $100 was worth 272 German marks. Thus, the nominal exchange rate between the dollar and the mark rose 50 percent between these dates. During the same period, prices in the United States increased somewhat more than the rise in prices in Germany. After adjusting for this difference, the real value of the dollar increased by 56 percent. Thus, in comparison to its purchasing power at home, the dollar's purchasing power in Germany rose by 56 percent.

The dollar's rise reflects the increased attractiveness of investing in dollar securities relative to the attractiveness of investing in foreign securities. The attractiveness of investing in dollar securities depends on the expected real rate of return on those securities and on the uncertainty of that return.

The expected real return depends primarily on the balance between national saving and investment demand. The large projected budget deficits in the United States imply a lower

national saving rate in the future and therefore a higher real rate of interest. This rise in the real interest rate is reinforced by the 1981 tax changes that increased the incentive to invest in business plant and equipment. (In addition, the tightening of monetary policy that began in 1979 may have temporarily raised the expected real long-term rate of interest.)

The rise in the real rate of interest has been quite substantial. The Treasury bill rate in 1983 averaged 9.4 percent, 5.2 percentage points more than the 4.2 point rise in the GNP deflator. This 5.2 percent real interest rate was substantially higher than the average 1.3 percent real rate on Treasury bills over the past 30 years. Although the long-term real rate is more difficult to assess than the short-term real rate, there can be little doubt that the real long-term interest rate has also increased significantly in the past few years. The current nominal interest rate on 10 year government bonds is nearly 12 percent, virtually identical to the corresponding rate in 1980 when consumer prices were rising at a double-digit rate. The decline in expected inflation since 1980 has raised the real interest rate by an equal amount.

A more uncertain or less predictable return reduces the attractiveness of any investment. In comparing the riskiness of investments in different countries, it is useful to distinguish political risks from economic risks. The political risks associated with investing in American securities are

clearly lower than the risks in many other countries. Moreover, when political turmoil increases in the world, funds may seek investment opportunities in "safe haven" countries like the United States. It is difficult to assess how much -- if at all -- the search for safe haven investments has strengthened the dollar in recent years relative to the currencies of other politically stable countries.

A decline in the economic risk of investing in dollar securities is likely to have been a more important reason for the increase in the dollar's value. The most important source of decline in economic risk has been the change in monetary policy. The firm anti-inflationary stance adopted by the Federal Reserve in late 1979 and pursued in 1980 and after reassured investors in the United States and abroad that the dollar would no longer face the potential of runaway inflation.

In summary, the combination of a sound monetary policy that reduced the riskiness of dollar investments and the rise in the real return on dollar securities caused primarily by the large projected budget deficits has increased the attractiveness of investing in dollar securities. The result of this increased attractiveness is to raise the value of the dollar. Indeed, the dollar had to rise enough so that its expected fall over the coming years would offset the increased attractiveness of dollar securities.

Although the higher real interest rate is the mechanism

by which the budget deficit has raised the real value of the dollar, it is important to note that the dollar's value might not have increased if the deficit had caused a substantial increase in expected inflation. The confidence among investors worldwide that, despite our large projected budget deficits, the Federal Reserve will not pursue an inflationary monetary policy prevents such a deterioration of the exchange rate. A perceived shift by the Federal Reserve toward an inflationary monetary policy would be likely to cause an immediate decline in the value of the dollar and a continuing erosion of the dollar's nominal value in the future.

Inflation expectations are thus the key to understanding the apparent paradox that the projected U.S. budget deficits have strengthened the dollar while in so many other countries large budget deficits have been associated with falling currency values. In other countries, budget deficits have often been monetized and accompanied by inflation, which has led to the fall in nominal currency values. It may be the often substantial and persistent fall in nominal exchange rates caused by increased inflation that causes some people to associate budget deficits with declining currency values. When this is understood, there is nothing surprising about the fact that the dollar has appreciated in the face of enlarged budget deficits.

The Effect of the Strong Dollar

The most direct and obvious effect of the strong dollar has been the decline in exports and the rise in imports. The merchandise trade deficit -- the excess of the value of imported goods are the value of the goods that we export -- rose from $26 billion in 1980 to $36 billion in 1982 and more than $60 billion in 1983. This year we expect the trade deficit to exceed $100 billion.

This increased merchandise trade deficit represents substantial damage to American exports and to those firms that compete with imports from abroad. The enlarged trade deficit since 1982 is equivalent to nearly 2 percent of GNP and therefore to nearly 2 million jobs in these firms -- although it would be wrong to interpret this as a loss of total output or jobs, a point to which I shall return in a moment. There are also long-term adverse consequences as American firms relocate plants abroad and develop overseas sources of supply for components previously purchased in the United States.

The financial consequences of the trade deficit are particularly important. Part of the merchandise trade deficit can be financed by our exports of services like insurance and banking and by American earnings on overseas investments. In 1983, these ways of paying for our trade deficit fell short and we ended the year with a $41 billion discrepancy known as the current account deficit. This current account deficit is financed by a net capital inflow to the United States from the

rest of the world. That is, to the extent that we do not earn enough to pay for our imports, we must borrow from the rest of the world or reduce American investments abroad or sell domestic assets to foreign investors.

The United States was a capital exporter to the rest of the world throughout most years of the postwar period. This has now been reversed. The current capital inflows are now quite large. The 1983 net capital inflow of about $41 billion exceeded 1 percent of GNP. Net saving in the United States last year -- including the saving of households, businesses, pension funds, and State and local governments -- was only 1.9 percent of GNP after the borrowing by the Federal Government. The capital inflow of over 1 percent of GNP therefore raised the pool of available net funds by more than 50 percent and permitted net investment of 2.8 percent of GNP.

This year we anticipate a net capital inflow of about $80 billion, seven times the net capital inflow in 1982. This $80 billion capital inflow is more than 2 percent of GNP and is likely to be equivalent to more than half of all net private fixed investment in the United States. An $80 billion capital inflow will also equal about 40 percent of this year's budget deficit. Stated differently, the foreign capital inflow offsets some 40 percent of the crowding out of domestic investment that would otherwise occur.

There has sometimes been confusion about the extent to which the inflow of foreign capital finances the U.S. budget

deficit. Like so many debates, the controversy is more about definitions than about facts. The basic facts are that there will be an $80 billion capital inflow this year but that only a fraction of the $80 billion capital inflow will actually be used to purchase U.S. government securities directly. It is therefore not literally correct to say that foreign capital will finance 40 percent of this year's budget deficit. It is correct, however, to say that the foreign capital inflow finances borrowing or other investment equal to 40 percent of the budget deficit. In terms of the pressure on the American capital market and the overall level of U.S. interest rates, it obviously doesn't matter whether foreign investors purchase Federal securities directly or purchase private securities and make bank deposits that permit American investors to purchase those Federal securities.

One important consequence of the growing capital inflow is that the United States is rapidly shifting from a creditor nation to a debtor nation. Between 1950 and 1982, the net capital outflow from the United States -- including the reinvestment of our overseas earnings -- amounted to a total of $132 billion. The cumulative net overseas investment of United States investors at the end of 1982 was $169 billion. In 1983 and 1984, most of this investment will be eliminated by a net capital inflow of about $120 billion. Sometime in 1985 we can expect to become a debtor nation.

No lights will flash when we pass from creditor to debtor

status. Nor will there be any immediate adverse effects on the economy. Debtor status means simply that Americans will pay more in net interest and dividends to investors abroad than we will earn on our overseas investments. To say the same thing in different words, the United States will have to give some of each future year's GNP to our creditors abroad to pay for today's excess of imports over exports. The larger is our accumulated international debt, the larger will have to be our future trade surpluses to pay the net interest on our debt. This in turn means that the larger our accumulated debt, the greater will have to be the fall in the exchange value of the dollar to achieve the required trade surplus.

There is, of course, also a very important positive effect of the current capital inflow. The capital inflow supports the level of domestic investment and keeps the real interest rate from rising even higher. Without the net capital inflow of $80 billion in 1984, net investment would be only about half of the anticipated rate. Cutting the demand for net investment in half would be likely to require the real interest rate to rise very subtantially.

The trade deficit and the capital inflow thus represent a major shift in the pattern of economic activity. Without this international response, the budget deficit would crowd out even more of the activity in the investment goods industry, the construction industry, and other domestic interest-sensitive industries. The trade deficit is thus a safety

36-133 O—84——5

valve that spreads the budget crowding-out into other sectors of the economy.

It is wrong therefore to interpret the decline in net exports as a measure of the reduction in GNP caused by the strong dollar. The dollar's rise reduced the production of exports and of goods displaced by imports, but it also induced a capital inflow that expanded activity in domestic interest-sensitive industries.

The net effect on total output and employment is not at all clear. It is perhaps best to think of the process as a spreading of the crowding-out caused by the deficit.

Another important effect of the dollar's rise has been to lower the rate of inflation since 1980. A stronger dollar lowers the price of imports. This in turn puts pressure on the prices of domestic goods that compete with imports. When the dollar prices of French and Italian wines fall, the prices of American wines will also be induced to decline. The same is true for a wide range of other products. Similarly, the strong dollar lowers the dollar price that American exporters can get for their products abroad and this induces them to sell at lower prices at home.

The effect of this downward price pressure depends on the response of monetary policy. With no change in monetary policy or in the velocity of money, the strengthening of the dollar reduced the inflation rate and increased real growth. Real growth strengthens in this context because, with less

inflation, the unchanged stock of money can support more real economic activity. To the extent that the money gowth rate was slowed in response to the decrease in inflation, the effect of the stronger dollar would be to reduce inflation more and increase growth by less.

It would be wrong to conclude from this that the stronger dollar necessarily increased real growth. The velocity of money -- that is, the ratio of GNP at current prices to the value of the money stock -- declined substantially during the recent recession. It is not clear to what extent, if any, the sharp decline in net exports did decrease output while the reduction in the real interest rate did little to stimulate additional investment during a time of substantial excess capacity. Thus, the character of the recovery, and in particular the depressed level of net exports, may have caused a lower level of economic activity in 1983 than might otherwise have occurred.

The Dollar's Inevitable Decline

In the future, the real exchange value of the dollar must eventually fall. If the current strength of the dollar were to persist, the large current account deficit would also persist and grow. This is not possible, because the world's financial investors would not be willing to go on absorbing the ever-growing volume of U.S. public and private securities that would be implied by these expanding current account deficits. Thus the dollar must decline until the trade deficit

shrinks and the current account reaches a sustainable level much closer to balance.

No one can be sure how long it will take or how rapidly the dollar will fall. It could take the rest of the decade and beyond, with the dollar declining at a rate of 3 or 4 percent a year. Or it could happen very much more quickly with a drop of 20 percent or more in a single year. Or it could do something between those extremes.

Let me be very clear that I am not saying that there must inevitably be a continued decline in the dollar in 1984. Although some further decline in the dollar is likely this year, the same could have been said a year ago. It is possible that 1984 will see a repeat of last year's increase in the dollar's value.

There is now substantial interest in the possible consequences of a sharp decline in the dollar. To financial institutions, the dollar is an investment asset just like domestic stocks and bonds. A sudden change in expectations or sentiments could cause a sharp change in the value of the dollar even with no obvious cause or concurrent change in economic conditions. Alternatively, of course, a decline in the dollar could occur in response to a reduction in expected future budget deficits and therefore in the real long-term rate of interest. In short, the dollar could fall spontaneously because of a shift in sentiment or it could be induced to fall by a decline in the real long-term interest rate that results from lowering projected budget deficits.

The Effect of a Dollar Decline

What would be the effect of a decline in the value of the dollar? The obvious direct effect would be an increase in exports and a decline in imports. This improvement in the trade balance would induce a corresponding improvement in the current account balance.

Experience shows that these changes occur wih a lag because of delays in adjusting purchases to the changed competitiveness of the dollar. In the very short run, a decline of the dollar actually worsens the current account because the quantities of exports and imports remains unchanged while the price of imports rises. Indeed, a decline in the dollar would have virtually no net effect on the current account in the first year as a whole. But at the end of two years, a 10 percent decline in the dollar would improve the current account by about a $20 billion annual rate.

The decline in the current account deficit would mean a reduced capital inflow from abroad. Taken by itself, the reduced capital inflow would mean higher real interest rates in the United States and a lower level of domestic spending on investment and other interest-sensitive activities. The movement of the interest rates and domestic investment therefore depends very much on whether the fall in the dollar is induced by a decline in projected deficits or is a spontaneous reaction to a change in sentiment. A spontaneous fall in the

dollar would raise interest rates and depress interest-sensitive activities. In contrast, a fall in the dollar that is induced by a decline in projected deficits may instead leave the economy with lower real interest rates. The projected decline in the deficit would lower government borrowing by more than the decline in the capital inflow from abroad. As a result, with more funds available for private borrowing, real interest rates could come down and investment could rise.

Regardless of why the dollar falls, its immediate impact would be an increase in prices in the United States. A 10 percent decline in the dollar will raise the level of consumer prices by about three-fourths of 1 percent after twelve months and about 1.5 percent after two years. Just as the climb in the dollar helped to reduce inflation over the past three years, the future fall in the dollar will temporarily raise the rate of inflation. More accurately, with an unchanged path of money growth, a rapid decline in the dollar exchange rate this year would tend to raise the rate of inflation above the 5 percent rate that we have projected for 1984.

How would a spontaneous decline in the dollar affect the pace of economic expansion? Unfortunately, the effects of a dollar decline are complex and the net effect is uncertain. The decline in the dollar stimulates net exports and this is clearly expansionary. This is partially offset by the decline in investment that results from the decreased capital inflow, leaving a smaller but still positive effect on the level of

economic activity. There is, however, a third important effect: the fall in the dollar raises the domestic price level. With a fixed money stock, this raises the interest rate and further reduces investment and other interest-sensitive activities. On balance, the overall impact of a dollar decline can be either positive or negative. Calculations based on a range of plausible estimates of the magnitudes of the separate effects imply that the effect of a dollar decline on economic activity is ambiguous and cannot be resolved with any confidence.

Altering Economic Policy

It is only natural to conclude my remarks by considering whether it would be appropriate to alter policy if there is a sharp change in the dollar's value. For the sake of concreteness, I will discuss the appropriateness of alternative responses to a fall in the dollar.

Exchange Market Intervention

One possible response to a decline of the dollar would be exchange market intervention, buying dollars and selling other currencies in an attempt to raise the dollar's value. Since buying dollars in this way would reduce the money supply, it is customary to accompany such a transaction with an equal swap of dollars for outstanding government bonds. The effect of this pair of transactions is to leave the money supply unchanged but to increase the outstanding volume of foreign

currency or securities and to reduce the outstanding volume of U.S. government bonds. Because the money supply is kept unchanged, this form of exchange market intervention is known as sterilized intervention.

The experience of the United States and of other countries shows quite clearly that sterilized intervention in realistic amounts has little or no lasting effect on exchange rates. It is therefore the policy of the Reagan Administration to use exchange rate intervention only to calm disorderly markets. We recognize that any attempts to offset a significant shift of the dollar's value by sterilized intervention would be futile.

Monetary Policy

Preventing a fall in the dollar's value could however be achieved by a tightening of monetary policy. A reduction in the supply of money (either in exchange for bonds or for foreign currencies) would raise the interest rate in the United States and strengthen the dollar. But tightening money in this way would have the undesirable effect of reducing the level of economic activity below what it would otherwise be. A contractionary monetary policy would be particularly inappropriate if the net effect of the dollar decline itself was to reduce the pace of economic activity.

There are some who might therefore suggest the opposite type of monetary policy: a monetary expansion aimed at

offsetting any contractionary effect of the dollar's decline. Even if it were certain that the dollar's decline was contractionary, such a shift of monetary policy would be inappropriately risky. A more expansionary monetary policy would inevitably exacerbate the rise in the domestic price level caused by the exchange rate depreciation. Moreover, the combination of the initial exchange rate depreciation and the expansionary monetary policy could generate expectations of increased inflation, expectations that could easily depress the dollar further and thereby be self-fulfilling.

These considerations imply that it is best not to alter the monetary policy in response to an unanticipted and spontaneous decline (or rise) in the dollar's value. It is therefore appropriate that the Federal Reserve's target range for the monetary aggregates are not made conditional on the future course of the exchange rate.

Fiscal Policy

The best way to avoid the adverse effects of a dollar decline on the real interest rate and on investment activity is to see that the dollar decline accompanies a reduction in the anticipated future budget deficits. This provides a further reason why reducing the projected budget deficits is so important at the present time.

The Administration is firmly committed to reducing the deficit by a downpayment this year and by further legislative action in 1985. A deficit reduction of $150 billion over the next three years would be a meaningful downpayment on deficit reduction. This downpayment plus follow-up action in 1985 can put the budget on a path to balance and keep the economy on a path of solid growth with declining inflation.

The CHAIRMAN. Senator Long.

Senator LONG. What proposal are you referring to in your statement? Can you tell me what bill, specifically?

Dr. FELDSTEIN. I don't know. All I know is that the letter of invitation asking me to testify specifically said:

> We would also like your analysis of the applicability of section 122 of the Trade Act of 1974 to the current imbalance, and the utility of surcharges or quotas to deal with this imbalance.

And I have a similar letter from Congressman Gibbons in his invitation to testify in the House. It made such hairs as I have stand up on end, in fear of what this might portend.

Senator LONG. All right. Well, then, you aren't particularly concerned, I take it, about the situation that exists between the United States and Japan, where we are running a very large deficit, and to all indications we will continue to run a very large deficit indefinitely into the future.

Dr. FELDSTEIN. I think that it's wrong to focus on bilateral trade deficits. Our overall trade deficit is clearly a problem, but I think it's a problem, as I said in the prepared statement, that we wouldn't want to solve except in the context of a declining budget deficit, because if we do, all we will be doing is shifting the problem within the United States from our internationally competing industries to domestic interest-sensitive industries.

Senator LONG. Well, I suppose that we just don't move on the same assumptions. My thought is that, if you've got a problem that needs to be corrected, you ought to look to see where it's coming from. And when you see where it's coming from, then you are in a better position to judge how you ought to go about trying to deal with it.

Now, where are the principal areas that our trade problem is coming from? Well, one of the big items is our trade with Japan. There is not a thing they are manufacturing over there that we can't manufacture here.

Dr. FELDSTEIN. If we could make that go away—for example, if we increased our sales of oil to Japan, we could have a trade balance with Japan. But then we would have a trade imbalance someplace else. It wouldn't change anything in terms of the overall trade imbalance that the United States has.

Senator LONG. Well, I'm sure you heard me say when Ambassador Brock was on the stand that when I was first elected to the Senate, we were confronted with a series of unfavorable balances in trade, but I was told not to worry, that we had a huge surplus, that our investments abroad compared to their investments.

And here you say in your statement, Dr. Feldstein, that we will soon be a debtor nation. Does that make sense to you, that we would be a debtor nation? We were always supposed to be the richest Nation on the face of the Earth, as I think we are. Does it make much sense that in the international community we would be a debtor nation?

Dr. FELDSTEIN. It is clearly going to happen.

Senator LONG. At the rate we're going, there is not the slightest doubt about it.

Dr. FELDSTEIN. No doubt about it, it will happen.

Senator LONG. But does that make any sense, that we should be a debtor nation in the world community?

Dr. FELDSTEIN. Because we are a very low saver, and now we've gotten down to a savings rate which is trivially small, net of Government borrowing. It's not surprising that capital is flowing into the United States, and therefore we are putting ourselves in the position of becoming a debtor nation.

Senator LONG. But just on balance, we are becoming a debtor nation because of a combination of fiscal and monetary policies, and trade policies, that are making it that way. The question is, Does that make any sense at all, for us to be a debtor nation, when historically we have been a creditor nation?

Dr. FELDSTEIN. Let me pick up what you said before about not holding our breath, about getting back to a balanced budget. Let's take an optimistic view and assume that the Congress is going to pass and the President is going to sign legislation this year that will be a down payment on the budget deficit. We will come back in 1985 and do more, but nevertheless it is going to be a process that is going to take several years before we get back to a balanced budget.

Given that, is it a good or a bad thing that we import capital at the present time, given that we have this very low savings rate? Well, the alternative to importing capital is to have a very low rate of investment here, to run down our housing stock and to run down our plant and equipment in this country. If we can make better use of the foreign capital that comes in than the return we have to pay them, and if we can borrow more cheaply from the rest of the world than the return that we get at home on that capital, then that's making the best of a bad situation. Letting that capital come in is better than not letting it come in, given that we have these very large budget deficits at home over the next few years.

Senator LONG. Now, I admire you tremendously as a man who has had the courage to stand by his convictions about this deficit situation and try to persuade the President to see it your way, even though you have been chastised by those who for political reasons, or for whatever reasons, think that he shouldn't follow your advice. And in this area, I find myself thinking that if we are going to protect first one segment of the American economy and next another, going to look at their interests and protect them against the adverse effect of the fiscal and monetary policies that we're pursuing here in this country, I don't know why we couldn't give those people who are supporting this Government by working for a living every day the same type of consideration.

Dr. FELDSTEIN. The problem is that there is no way to avoid doing some harm to somebody in this area, as long as we have these large deficits. And I'm taking those deficits as going away gradually, and I'm saying, "What's going to happen?"

Well, last year we had private domestic investment, net of depreciation, equal to 2.9 percent of GNP. That's not a lot; 2.9 percent of GNP is a lot lower than the low numbers we have had in the past. It has averaged almost 7 percent over the last three decades. But more than a third of that 2.9 percent was financed by the capital inflow from abroad. If we didn't have that capital inflow from abroad, we would have had 1.9 percent of GNP invested last year,

and then this hearing would not be about the trade deficit but it would be about the problem that we have in housing, the problem that we have in modernizing plant and equipment, the problem that we have about unemployment in the capital goods industries.

I am saying that what we have here is a kind of safety valve, that, given tremendous pressure on the domestic capital markets, helps release some of that pressure. It does so at the expense of exporters and those who compete with imports from abroad. It spreads the pain around and makes the pain a little less intense than it otherwise would be.

Senator LONG. Well, I find myself frequently thinking about the Kentucky Colonel—you know, these people have all heard the story so many times, but I will tell it again—who was relating his experience in a duel. He was challenged to a duel, and he told his friend how he and his opponent turned and put their backs to one another on the field of honor and stepped off the 20 paces and turned around. And when the colonel turned, there his opponent was, standing behind a tree. And the fellow said, "Well, what did you do about that situation?" And the colonel said, "Quite natural, I throwed me behind a tree, too."

Now, there is a jungle out there. You can talk about all the trade rules you want to talk about, Dr. Feldstein, but that's a great big jungle out there that we are competing in. I haven't been out there in that free enterprise world competing for customers for a long, long time; but those who are there tell me that it's still that way, even inside this country, and that on an international scale it is even worse, where people engage in a great number of tactics, do all kinds of things to see that they make the sale and you don't. If you are getting the worst of it, you ought to find ways to take your interests and look after your people.

Now, they can shout about protectionism all they want; when the time comes, they look after theirs.

I have experienced the scorn of Europeans who have called me a protectionist, when I think the epitome of protectionism is their own agricultural policy.

But when we are getting the worst of it, and we look at how that's happening, I don't know how you achieve anything unless you do something to give yourself some leverage to work with.

Now, Secretary Connolly used the surcharge when he was Secretary of Treasury to try to get our trade situation into a better hand. Do you disapprove of what he did when he was Secretary of the Treasury?

Dr. FELDSTEIN. The circumstances were very different. That was before we went to a floating exchange rate, it was in the process of shifting to a floating exchange rate. I think at this point putting on a surcharge of the sort that Connolly did would be a very bad thing to do.

Senator LONG. Well, there are a lot of us, and I'm one of them, who have to be concerned about the situation where, through no fault of the people who are out there working day by day, wherever they are, they find themselves being put out of their jobs because other nations take a greater degree of interest in seeing that their people have the market than our Nation takes in seeing that our people have the market.

Dr. FELDSTEIN. Let me just reiterate that if, somehow, we could reduce the trade deficit now, and with it the current account deficit, we would find more jobs in our export firms, we would find more jobs in firms that compete with imports from abroad, but we would find fewer jobs in construction in this country, and we would find fewer jobs in the capital goods industry, and 5 years from now our manufacturing firms would be less competitive because they would have had less capital with which to modernize. We would see ourselves with much higher interest rates.

Senator LONG. It doesn't particularly bother me to see the trade situation used to put pressure on labor to be more competitive, to be more productive, and even to settle for lesser wage demands; but it does concern me very much to see a lopsided situation where just a lot of our good people are going to be forced out of jobs through governmental policies that do not correspond to what the other side is doing.

I can recall a time when a witness sat there in the same place you are sitting, many years ago, at least 12 years ago, and described a situation of competing in Japan as "Japan, Incorporated." He said that in that country the Government and the industries are one. They work together just as a unit. And the industry is 100 percent backed by their Government and vice versa, and when you are competing with them it is all one unit. He said, "Even General Motors"—and at that time I thought it was ridiculous for a man to say this—"Even General Motors can't effectively compete with that."

And I think that time has proved that what he said was correct. Now, that's what you are dealing with. How do you justify just ignoring that and going right on ahead as though you weren't dealing with someone who is engaged in state trading or engaged in the kind of trading the Japanese are doing?

Dr. FELDSTEIN. Let me be very clear; I am not in any sense saying that we shouldn't press fully for entry into the Japanese market. I think that what the President's discussions with Nakasoni in Tokyo did and what the followup negotiations are all about is very important, making sure that they not only agree to things like allowing NTT to buy from the most competitive provider, including American providers, but that they actually carry through on that. And, as Ambassador Brock said, American industry now feels that we have been successful in getting them to take that seriously.

I think we have to keep doing that. There are a number of other things, that you are no doubt aware of, in which we have very explicit, direct, hard negotiations going on with the Japanese now, to make sure that they treat our firms fairly. That's true. That's important. It will not necessarily have an effect on our trade balance with Japan; it may change the nature of it.

Senator LONG. But it is not going to make much difference if you do it the way they are doing it now; but if you give yourself the leverage to make them do business with you, it would be an entirely different matter. The approach that Secretary Connolly was using, for example, tends to give you the leverage.

Now, I am told that over in Japan at that point, when he proposed that surcharge—I can't prove this, but I was told it, and I am

just telling this to you for whatever it might be worth—that one big Japanese exporter was told by his government, "Go ahead and ship that stuff right on into the U.S. market. The Government, if need be, will pay that surcharge for you." So the surcharge was totally irrelevant in regard to that particular line of products. I don't know whether that is true, but someone told me that.

I have been told by others at a later date, in just trying to see what it would cost to get an American product into Japan—just to find out what it would cost to do it—they couldn't even begin. They couldn't get into that market, period.

So, when you are confronted with a nation that stands together as a unit with their producers as Japan is now, and the Prime Minister comes over here and agrees to what would amount to about a drop in the bucket, and he is all but impeached when he returns home, it leads me to believe that you aren't going to negotiate that away, you aren't going to get reciprocity with the Japanese by negotiating that away; you are going to have to arm yourself with some leverage, something to negotiate with, which would be something much stronger than Secretary Connolly had, if what I heard about this matter proves to be correct. You would need a higher degree of leverage than that.

But if you wanted to use it, I have no doubt that you could work out an arrangement with the Japanese that would be to our advantage.

I take it you wouldn't favor anything like that.

Dr. FELDSTEIN. That is absolutely right, if by that what you mean is that we unilaterally and in violation of GATT impose a 10–20–30 percent tariff on the Japanese products as a bargaining position, but we are willing to just keep it in there, I think that would be a terrible mistake.

Senator LONG. I am not talking about whether you are violating GATT or not violating GATT.

Dr. FELDSTEIN. Well, that's very important to us. We are a country that really does depend upon having growing trade rather than shrinking trade.

Senator LONG. Well now, I am familiar with a little bit of the GATT background. The Congress has never subscribed to that basic GATT contract. We ratified the Tokyo round, we ratified the Kennedy round, this other round negotiated; but the basic GATT agreement, Congress would never subscribe to.

Now, we are not bound to that, and I think we would be unwise to bind ourselves to it.

I know how every other nation is going to do business if they find a situation that they can't live with. For example, if you apply it to us, we negotiated that agreement at a time when we could afford to be generous and could let the other guy get all the best of it. But any nation that is a signatory of that treaty, if they find the situation is so bad that they can't continue to live with it, they are not going to live with it; they are going to say, "I'm sorry, we are not going to continue to do business that way." And you will have to work it out with them however you can, because I know this: The record in that regard showed that nobody is going to go to war with somebody because he can't comply with the GATT agreement. He is just going to have to find a different way of doing business.

We aren't at war with Saudi Arabia, are we? We are not at war with the OPEC cartel. In the last analysis, if they won't do business by the GATT agreement, you just have to find some other way to work it out with them.

And at some point, I think we have to look at our interests, and say, "What's best for the United States?"

Dr. FELDSTEIN. But our interests are ambiguous in this area. It is true that our interests, in some sense, are to be able to sell more abroad; but our interests also are to be able to borrow abroad, particularly at this time when our budget deficits are so large.

Senator LONG. Well, I understand what you are saying Dr. Feldstein, and I know that most economists agree with you—that's what they are taught in Harvard, and that's what they are taught in other places. And it is almost heresy among the economics profession to take the attitude I take about this matter. But I know how the people of this country think about it. When you say in the long run all this thing is going to work out, it will all work out fine, my reaction to that is, "Yeah, that's assuming that some rascal doesn't mess it up between now and then." And invariably there's somebody there at the switch who is putting the train off the track, or for some reason keeping it from working out the way it's supposed to be. It's just like it is in Japan right now when you try to get certain lines of products in there that they would prefer not to have in their market. Theoretically, you can get it in, but as a practical matter you can't.

I don't think you correct all of that by negotiating it away. It seems to me as though at some point you've got to arm yourself with enough leverage to where they are going to have to deal with you.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Mr. Chairman, I have a question, but I will ask it at the close of the hearing.

The CHAIRMAN. As I understand your testimony—and again, we may submit some questions in writing—I guess you would suggest that section 122 is simply a dead letter. You don't care much for it at all; is that correct?

Dr. FELDSTEIN. That's right. Certainly I wouldn't like to see it used at this time and under these circumstances.

The CHAIRMAN. Well, there is precedent for surcharges by France and Canada, the United Kingdom, and the United States. But again, I think that is the question we raised in our letter, to see if there was any administration interest in that, for many of the reasons that Senator Long has discussed.

I think the more important thing is that we have been focusing on the deficit, and we haven't spent enough time on the trade deficit. We are going to spend some time now, since our committee has completed its work—in a bipartisan way, I would add, with a unanimous vote to deal with the Federal deficit. We are now going to shift to what we may do on the trade deficit. We have a lot of things in mind, so we will probably be hearing from you again.

Dr. FELDSTEIN. I am always happy to talk to this committee.

The CHAIRMAN. Thank you very much.

I am going to ask the remainder of the witnesses if they might all just come to the table at once—Mr. Wallich, Deputy Secretary

McNamar, Mr. Bergsten, and Mr. Roach. You all know each other, anyway.

Let's see, Governor, do you want to start off?

Governor WALLICH. All right.

STATEMENT OF HON. HENRY C. WALLICH, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Governor WALLICH. Mr. Chairman, in many respects my testimony resembles the analysis that Mr. Feldstein has produced, and I will be as brief as I can.

We have these very large trade deficits and current account deficits. I see four main reasons for these deficits: First, the high dollar; second, the cyclical phase of our economy, with the strong expansion ahead of other countries; third, particular problems with developing countries that had to cut back severely on their imports; and fourth, specific problems with industries that have not fully adjusted, have not fully kept up, and as a result have encountered problems both in exporting and even more in import competition.

If the high dollar is the principal cause of the trade deficit, one has to look at the causes of that. I see the principal reason for the high dollar as high interest rates produced by the high budget deficit.

There are other reasons, besides. This is a very good country to invest in; foreigners are attracted to bring their money here by a lower rate of inflation, by a reasonable tax system, by political stability. All these factors weigh, but I think the fundamental factor is the attraction of high interest rates in a country that saves very little and spends a large part of its small savings on a large budget deficit.

The damage that I see from the deficits and therefore from the strong dollar is considerable, but not of a kind that cannot be retrieved. The longer the present situation remains, the more difficult it will become to retrieve lost export markets, but to the extent that the dollar can go down again, those markets can be retrieved.

Where I do see a serious danger is the United States becoming heavily indebted abroad. Whether one calls that "becoming a debtor country" is perhaps a matter of definition. The statistics are ambiguous. But eventually our international investment income, which has been of the order of $30 billion net in recent years, will become small and maybe negative and we'll have to earn via exports what we don't earn by our investment income. That means a still lower dollar and a still greater difficulty of making our ends meet.

The large deficit itself, of course, is likely to affect the dollar. It is unlikely that foreigners will want to keep accumulating the securities that they have to buy, the dollars that they have to buy, indefinitely. And so eventually the demand for dollars may diminish in the world. The dollar would go down. For that reason, I do not believe that the current value of the dollar is sustainable, although it is impossible to predict the sequence or timing of events that will bring about its decline.

Now, if the dollar goes down, a large part of the problem that your committee, Mr. Chairman, is looking at—the trade deficit—will tend to disappear. But other fundamental problems will emerge—namely, as Mr. Feldstein said, we will not be laying off some of our deficit on the rest of the world, importing the capital that has made it easier to finance our situation so far.

Looking at all this broadly, I do not see that we have suffered irretrievable damage, and, accordingly, I do not see a reason for drastic measures such as trade controls and trade restrictions under the legislation that would be available. I think that, while trade restrictions might resolve some particular industry problems, it would create new problems for other industries and certainly damage the consumer across the board. So I think that is a self-defeating approach.

The one approach that commends itself is not artificial measures of some kind to restrict trade or affect the value of the dollar, but the basic action of reducing the budget deficit, which will bring down interest rates and will help the dollar find a reasonable level.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared statement of Hon. Henry C. Wallich follows:]

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Statement by

Henry C. Wallich

Member, Board of Governors of the Federal Reserve System

The U.S. Trade Deficit: Causes, Consequences and Policy Options

SUMMARY POINTS

1. The strong dollar and our large trade and current account deficits are related in a fundamental sense to the large federal budget deficit.

2. Import restricting actions, whether broadly or narrowly applied, are contrary to the national interest of the United States, except where foreign competition is judged to be unfair as defined by our trade acts.

3. The only appropriate policy prescription for beginning to deal with the trade and current account deficits and avoid an excessively strong dollar, in my view, is to reduce the structural deficit in our federal budget. Other proposals for reducing the external deficits without reducing the budget deficit would, if successful, only shift the impact of our nation's budget problems by putting upward pressure on real interest rates.

The U.S. Trade Deficit: Causes, Consequences and Policy Options

The U.S. merchandise trade and current account deficits widened considerably during 1983. For 1983 as a whole, the trade deficit exceeded $60 billion, and by the fourth quarter it had reached a $75 billion annual rate. The current account was in deficit by more than $40 billion for the year as a whole, and reached a $60 billion annual rate in the fourth quarter. Many are predicting that the current account deficit will be around $80 billion for 1984 as a whole, and the trade deficit around $100 billion.

Causes of the External Deficits

It is customary to analyze changes in the external deficits by focusing on proximate causes, such as changes in exchange rates and the growth of economic activity at home and abroad. In that tradition, the widening of the external deficits can be related, first and foremost, to the very substantial appreciation of the dollar and the conditions that have given rise to the appreciation. On a weighted-average basis against the currencies of the other major industrial countries, the dollar has appreciated by more than 45 percent since the fourth quarter of 1980, when our current account balance was showing a small surplus. Some of the appreciation has reflected our relatively good inflation performance, but even in real terms -- adjusted for changes in consumer price levels -- the weighted-average value of the dollar is now nearly 40 percent higher than it was at the end of 1980, and roughly 25 percent higher than its average for the entire floating rate period since 1973. Against the European currencies the appreciation in real terms has come to 30 percent against the Swiss franc, 45 percent against the German mark, and higher amounts against the weaker currencies. Against the Japanese yen the dollar has risen 20 percent in real terms; against the Canadian dollar it has depreciated slightly.

The cyclical behavior of the U.S. and foreign economies has been a second factor contributing both to the time profile and to the widening of the U.S. trade deficit. The U.S. recession held down imports and thus delayed the rise in the trade deficit until after the middle of 1982, and the relatively rapid expansion of the U.S. economy in 1983 was a dominant element in last year's trade developments, accounting for more than half of the $30 billion increase in our trade deficit from the fourth quarter of 1982 to the fourth quarter of 1983.

As a third factor, the external financing problems of some countries, especially of our neighbors in Latin America, have resulted in lower exports to these countries.

A fourth factor has been the failure in the past of some of our industries to adjust adequately to the pressures of international competition.

While the strong dollar and our large external deficits reflect, in part, our improved macroeconomic performance and the greater return on financial investment in this country, in a more fundamental sense they are related to the budget deficit. When the U.S. government runs a deficit, other sectors must, on balance, finance it. Part of the financing has been provided by foreigners in the form of the net capital inflow that is the counterpart of the current account deficit. The remainder of the financing has been provided by private domestic residents and state and local governments, which has diverted resources from productive domestic capital formation. Naturally, the net capital inflow and the surplus of private domestic saving over private domestic investment have not arisen automatically, but have had to be induced. As a result, real interest rates have been higher then they would otherwise have been. In addition, the higher real interest rates have been associated with upward pressure on the

dollar: such upward pressure has prevailed over whatever downward pressure may have emanated from the external deficit, which usually is a negative element in the market's evaluation of a currency. Thus the dollar has risen. In this way, high real interest rates, the strong dollar, and large external deficits are all linked to large federal budget deficits.

Consequences of the Deficits and the Strong Dollar

Some of the damaging consequences of the deficits and the strong dollar are reflected in the decline in our exports. In value terms, exports declined by about $25 billion from the fourth quarter of 1980 to the fourth quarter of 1983, with two-thirds of the drop accounted for by a 40 percent contraction of shipments to Latin America, mainly to Mexico, and the other third reflecting a 15 percent reduction in shipments to Western Europe. It is noteworthy that exports to both Japan and Canada expanded somewhat from 1980 to 1983.

In volume terms, our merchandise exports were more than 15 percent lower in the fourth quarter of 1983 than in the fourth quarter of 1980. Exports of capital goods declined by more than 25 percent in volume terms, exports of nonagricultural industrial supplies by more than 20 percent, and exports of agricultural products by about 10 percent. The longer exports remain depressed, the more difficult it becomes to maintain marketing networks, and the more costly and difficult it becomes to recover foreign sales.

If our current account deficit were to continue for long at the rate of around $80 billion that is likely to be recorded in 1984, the United States would soon become an international debtor country. At the end of 1983, the United States had an estimated international net creditor position of about $125 billion. This balance could be pushed to the minus side in little more than one

year. Our position as an international creditor has been a major support to our balance of payments so far. Thanks to the very productive character of some of our foreign assets, the United States had a surplus of investment income averaging more than $30 billion annually during the years 1979-81. This has meant that we have been able to tolerate a sizable trade deficit without thereby incurring a deficit in the current account, which combines services and trade. If our international position shifts to that of a debtor country, this advantage will be eroded; indeed, it is estimated that our surplus of investment income fell below $25 billion in 1983. Eventually, the United States might find itself in the position of having to earn a surplus in the trade balance in order to cover a deficit on investment income. Other things equal, the larger the net debtor position we build up, the lower will be the value of the dollar necessary in the long run to generate the required trade balance.

In addition, I might say that, for one of the richest countries in the world, it seems hardly appropriate either to be borrowing currently on a massive scale from the rest of the world or to be a net debtor to it.

The external deficit also has a strong bearing on the future of the dollar. I have noted the severe appreciation the dollar has experienced against a number of currencies, which has been one -- but only one -- of the reasons for the trade deficit. As the United States continues to borrow abroad and moves toward net debtor status, causing the rest of the world to hold ever larger amounts of dollar-denominated assets, the good acceptance that our currency has had in the world may wear out. Nobody can predict the timing, but in the longer run it seems probable that the dollar-depressing effect of the external deficit will begin to overwhelm the dollar-supporting effect of higher interest rates.

I do not believe, therefore, that the current value of the dollar is sustainable, although it is impossible to predict the sequence or timing of events that will bring it down. If the dollar does decline substantially while the budget deficit remains unchanged, the external deficit will, with a lag, also decline. That would reduce, in a sense, the magnitude of the problem that this Committee is addressing. It would also, however, intensify other problems created by the budget deficit. With a return of the external sector toward balance, the foreign financing of the budget deficit would cease. It would have to be financed entirely at home, absorbing a still higher fraction of scarce available savings, thereby raising interest rates. The "crowding out" resulting from the budget deficit, which now goes in part against the foreign-trade related sectors of the U.S. economy and in part only against other sectors of the economy, would then be directed fully against the other sectors. This needs to be emphasized in order to make clear that a reduction or ending in the external deficit, without a reduction in the budget deficit, would only shift the impact of our nation's budget problems without resolving them.

The impacts of the external deficit and the strong dollar have been felt by our manufacturing industries, the agricultural sector, and some of our services industries. The effects are adverse not only for exports, but also for domestic import-competing sectors. On the whole, nevertheless, these impacts have been quite well absorbed. The American economy has expanded strongly. This has offset some of the pressure of mounting import competition deriving from a strong dollar. Moreover, some of the industries that have suffered from import competition are in that condition more because of factors specific to their industry than because of the high dollar. Industries that have failed to invest

and reduce costs, have not kept up with modern technology, and in some cases have paid wages far above the national average for production workers, are bound to suffer even at a lower level of the dollar.

Aside from such industry-specific problems, I do not see the United States being deindustralized. The combined domestic and foreign demand for U.S. industrial output has increased since 1980. In particular, the industrial production index for manufacturing is currently almost 7-1/2 percent higher than its level at the end of 1980, when the dollar began to appreciate. Employment in the manufacturing sector, on the other hand, is currently 3-1/2 percent below its level at the end of 1980, partly reflecting relatively rapid productivity growth in the manufacturing sector, which historically has contributed to a negative trend in the share of manufacturing employment in total private employment.

Arguments Against Import Restrictions

My purpose in citing these statistics is to counsel strongly against additional import restrictions at this juncture as a means of dealing with the trade deficit. The type of import restricting actions authorized by Section 122 of the Trade Act, which would apply on a broad and uniform basis, are certainly contrary to the national interest of the United States. Thanks to the strong economic recovery last year, our tradeable-goods industries as a group have not been severely injured on balance. Their circumstances cannot justify additional import restrictions, except where foreign competition is judged to be unfair as defined by our trade acts.

The costs of import protection are well known. The decision to protect one industry invariably imposes costs elsewhere in the economy. It is costly to other industries if foreign countries retaliate against U.S. exports, of if import restrictions lead to higher dollar exchange rates than would otherwise prevail, or if the prices they must pay for inputs rise. Protection typically leads also to higher prices and less choice for consumers. An example of the consequences of protection for consumers we now observe in the recent very high profits of the automobile industry, which is protected by "voluntary" export restraints in Japan. Finally, protected industries typically delay making the adjustments that are necessary if they are ever to stand on their own feet. These costs should make us hesitant even to reciprocate against foreign protectionist actions. Retaliatory measures taken by us damage our own interests, whatever they may do to foreigners.

Reducing the trade deficit by protectionist methods without reducing the budget deficit would not resolve our problems. It would certainly not ease the pressures on our export industries which, thanks to the discipline of international competition, are bound to be among our most efficient.

Other Policy Options

The appropriate policy presciption for dealing with the trade deficit and the excessively strong dollar, in my view, is to reduce the structural deficit in our federal budget. Controls on trade or on capital inflows, or any other proposals for reducing the external deficits without reducing the budget deficit, would only shift the impact of our nation's budget problems by pushing up real interest rates.

You have asked, as well, for an analysis of whether the floating exchange rate system itself may have contributed to our problems. In my view, the floating rate system has served us fairly well. Swings in exchange rates over the past decade, to be sure, have been extremely wide. But many of these swings can be related mainly to changes in the relative outlooks for interest rates, inflation and real growth in different countries. A good part of the changes in relative economic outlooks in turn can be related to changes in monetary and fiscal policies. Given the stances of monetary and fiscal policies in the United States and abroad during the past four or five years, it is hard to believe that the Bretton Woods system of pegged exchange rates would have survived, and certainly not without major upward adjustments in the exchange value of the dollar. Greater stability of exchange rates, which is greatly to be desired, must be founded in the first place on greater domestic stability in all countries, and on policies supporting this stability.

Finally, you raised the question of whether the dollar is overvalued. In my view, the meaningful answer to this question is yes. It is sometimes argued, to be sure, that whatever exchange rate prevails in the market at any moment balances demand and supply and therefore cannot be over or undervalued. That, however, begs the question. Interpreting the question as referring to the effect of the exchange rate on the economic magnitudes in which this Committee is interested, such as the trade balance or the current account, it seems evident that the recent value of the dollar has been clearly inconsistent with even very approximate balance in either the trade or the current account and that, therefore, in this sense, the dollar is overvalued.

Given this interpretation of our situation, the right policy prescription for dealing with the trade deficit is to deal with the circumstance that is at the root of the high dollar. This brings me back to the need to reduce the structural deficit in our federal budget. Such action, of course, would not cure all the diverse problems encountered in the various sectors of our economy. But a substantial adjustment of the budget toward balance, other things equal, would lead to declines in real interest rates, a depreciation of the dollar in exchange markets, and (with some lag) a reduction in the external deficits. Recent statements by the President and members of Congress, such as the statement of the Chairman of this Committee announcing these hearings, give hope that some progress may be made in that direction. I hope that my remarks have conveyed the message that the strong dollar and large external deficits are partly symptoms, themselves damaging, of large budget deficits. I hope as well that the Congress and the Administration will resist temptations to try to suppress the symptoms without curing the disease.

The CHAIRMAN. Tim.

STATEMENT OF HON. R.T. McNAMAR, DEPUTY SECRETARY, DEPARTMENT OF THE TREASURY

Secretary McNAMAR. Thank you, Mr. Chairman.

I have a full statement, Mr. Chairman, and a brief statement I will try to touch on here, with a couple of charts.

First let me say, at the outset, that I think this committee's action, bipartisan action, as you point out, in trying to reduce the budget deficit is a major step toward rectifying the problem that you are concerned about today. And I think the committee is to be commended by the administration.

Let me say quickly that as you look at the trade deficit growing to about $100 billion this year, one is sometimes led to think that the whole problem is with Japan. But in fact, our deficit with Japan has only widened by $4 billion in the last 2 years, between 1981 and 1983. That is mainly due to higher U.S. imports, and we need to talk about why we have those higher imports.

If you look at the first chart, the largest trade balance decline has been with Mexico. As a result of Mexico's financial problems, our exports to Mexico dropped by roughly half since 1981, from $18 to $9 billion, and with rising U.S. imports our balance with Mexico worsened by $12 billion. Adding another $10 billion decline with other less-developed countries, our overall trade balance in the non-OPEC LDC's worsened by $22 billion between 1981 and 1983; debt problems in Eastern Europe probably added another $1 to $1.5 billion. And in total, as Marty said, we estimate at Treasury that

that has probably cost us somewhere between $25 and $30 billion shift there.

Now, if you look at the factors causing the widening trade deficit, we think there are three major factors—the strength and timing of the U.S. recovery, the declines in our exports to developing countries which are experiencing the financial problems, as I said, and the appreciation of the dollar in the exchange markets over the past 3 years.

I have summarized the impact of these factors on the next chart as they relate to increasing the trade deficit—the strong and early U.S. recovery, the slower and weakened recovery abroad, the LDC debt problem, and the dollar appreciation.

If you look at that dollar appreciation impact, where we have a $25 to $100 billion range, I am embarrassed to come up here and give you a range that is that broad. However, I would suggest that anyone who gives you a more precise number than that either is disingenuous or not very analytically rigorous.

The factors tending to reduce the trade deficit in the future are improved U.S. competitiveness, foreign recovery that is now taking place, some resolution of the debt problem, dollar depreciation, and opening up foreign markets for goods, services, and capital. And there, I certainly agree with what Senator Long said about the need for Japan to open up its markets. I talked to Secretary Regan about that last night.

The CHAIRMAN. Did you get any good news from Secretary Regan?

Secretary MCNAMAR. I didn't get any good news from Secretary Regan, and I was disappointed, because I have to say that as far as the Treasury Department is concerned we think that for the second-largest economic power in the world not to assume its full responsibilities and begin acting like the second-largest economy in the free world is a severe disappointment. The pace of the progress is not satisfactory.

The dollar has appreciated substantially against all major currencies over the last 3 years; yet, interestingly enough, I would point out that interest rate differentials have moved against the dollar both in nominal and in real terms. It is notoriously difficult to measure real interest rates, since inflationary expectations play a central role. Work we have done at the Treasury suggests that movements in real interest rates and real exchange rates are also not closely correlated. If you use alternative techniques to deal with the problem of measuring expected inflation in the United States and other countries, however, they can yield a wide variety of differing estimates. And this depends, in part, Mr. Chairman, on whether you use a single variable regression analysis or multiregression analysis, and what periods you pick.

But I think that, more fundamentally, both the appreciation of the dollar over the past 3 years and its recent depreciation reflect the normal working of the international adjustment process. The concept that the dollar has become overvalued, while intuitively appealing, is a misleading guide to economic policy. Most estimates of the degree of the dollar overvaluation are based on the assumption that the exchange rate between any of two countries should move only to offset differing national inflation rates so as to keep

the international price competitiveness of traded goods unchanged. But in fact, the vast bulk of transactions in the foreign exchange markets are not trade transactions, they are capital transactions, and the dynamics of the foreign exchange market reflect that fact.

I might make one point further, if we can find chart 7: There have been claims that the trade balance is leading to a deindustrialization of America, creating an unbalanced economic recovery. I keep hearing about an unbalanced and uneven economic recovery, but, like pornography, I never know it except when I see it. If you look at chart 7 here, I think you will see that our 6.2 percent real GNP growth rate during 1983 is about in line with the growth at the same stage of previous recoveries; and also that the pattern of that growth was healthy. Consumer spending—particularly durable purchases—housing, business investment, and even exports all made greater contributions to this recovery than in previous ones. Weaker than average contributions came from Federal, State, and local government spending, and from net exports, which you are interested in.

What is particularly striking is that interest-sensitive categories all made greater than average contributions to the recovery, and that business investment, which is so crucial to sustained growth, is booming most of all.

I think I might stop here and simply indicate that Treasury joins the rest of the administration, of course, in opposing the imposition of import surcharges or quotas under section 122. And I will try to leave time for my colleagues and some questions.

[Secretary R.T. McNamar's prepared statement and charts 2, 3, and 7 follow:]

STATEMENT OF THE HONORABLE R. T. MCNAMAR
DEPUTY SECRETARY OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
March 23, 1984

Mr. Chairman, Senators, it is a pleasure for me to appear before this Committee to discuss the U.S. trade deficit. The trade deficit is a complex and increasingly controversial topic. Complex, because it responds to changes in U.S. and foreign economic conditions as well as to U.S. and foreign trade policies, the availability of trade finance, and the marketing and investment activities of individual firms. Controversial, in part because perspectives inevitably differ on both the causes and significance of the trade deficit, but also because trade policy usually has to balance strong conflicting interests.

Shifts in the U.S. Trade Balance

The dimensions of the trade deficit are reasonably familiar to all of us. Measured in the way that it enters our overall balance of payments, the trade deficit averaged $30 billion per year from 1977 to 1982. Last year it grew to $61 billion, and most forecasts suggest it will reach about $100 billion this year (Table 1).

Not as many of us are familiar with how the U.S. trade balance has been shifting in different markets (Table 2). Given the hue and cry about Japanese exports, one would expect to find that our trade deficit with Japan was a leading cause of the widening of our trade deficit. In fact, our deficit with Japan only widened by $4 billion between 1981 and 1983, mainly due to higher U.S. imports.

U.S. trade with other industrial countries has not held up as well as our trade with Japan. Since 1981, our exports to these countries have fallen $15 billion, and our trade balance with them has swung from a $13 billion surplus to an $8 billion deficit last year.

In fact, by far the largest U.S. trade balance deterioration has been with Mexico. Our exports to Mexico have dropped by roughly half since 1981, from $18 billion to $9 billion last year. With rising U.S. imports, our balance with Mexico swung from a $4 billion 1981 surplus to a deficit of $8 billion last year. Adding in smaller declines with other less developed countries, our overall trade balance with non-OPEC LDCs worsened by $22 billion from 1981 to 1983.

Bucking the tide was our trade with OPEC member countries. Driven by forces set in motion by OPEC itself, oil consumption in the United States and other oil-importing countries has continued to plummet, helping to drive down oil prices. The combined impact of these forces has helped trade balances in all oil-importing countries -- particularly the United States.

U.S. oil import volume, which had already fallen 32 percent from its peak by 1981, dropped another 17 percent between 1981 and 1983. The average cost of our imported oil also dropped 17 percent, from $34 per barrel to just over $28 per barrel. Most of the reduction in U.S. oil imports came in our imports from OPEC, which dropped by half, from $50 billion in 1981 to $25 bilion last year. While OPEC in turn had to cut back imports from the United States by $6 billion, the net impact on our trade balance was still positive by $19 billion.

Trade performance by commodity group has fewer surprises (Table 3). U.S. oil imports dropped by $24 billion from 1981 to 1983. Other imports, which had fallen in the 1982 recession, recovered strongly in 1983 and stood $19-1/2 above their 1981 level. Our exports, in contrast, continued to fall on a year-over-year basis. Agricultural exports in 1983 stood $7-1/2 billion below their 1981 peak, and non-agricultural exports were down $29-1/2 billion.

Taking into account U.S. trade in both goods and services, as well as transfer payments and receipts, the U.S. current account swung from a surplus of $4-1/2 billion in 1981 to a $41 billion deficit last year (Table 3). In addition to the $32-1/2 billion widening of our trade deficit over this period, there was a $1-1/2 billion increase in net U.S. transfer payments abroad and an $11 billion decline in our surplus on net service transactions. This decline came almost entirely through reduced net income on our overseas investments. While we expect some recovery in investment income, next year's current account deficit will likely be in the $70 to $80 billion range.

These are very large figures, both in absolute terms and as a percentage of our Gross National Product. They lend themselves to dramatic rhetoric and calls for urgent action. In my remarks today, I will address a number of important issues which need to be borne in mind by the Congress and by the Administration in reacting to these requests. These issues include the causes of the widening of our trade deficit, the impacts of the deficit on both the American economy and the rest of the world, and our views on the appropriate policy response.

The Causes of a Widening Trade Deficit

In broad terms, there have been three major factors in the widening of our trade deficit. These are: the strength and timing of the U.S. economic recovery; declines in our exports to

developing countries which are experiencing financial problems; and the appreciation of the dollar on exchange markets over the past three years. Table 4 gives rough orders of magnitude for the impact of each of these factors.

In the United States, the trough of the last recession came late in 1982. During 1983, our real GNP expanded 6.2 percent -- a strong rebound, and about in line with the first year of other recoveries in the postwar era. Real growth in other major industrial countries, in contrast, was only 3 percent last year, and even by the end of the year a sustained upturn was not yet underway in some of those countries. Furthermore, while signs are that a strong U.S. recovery is persisting into 1984, as reflected in our budget forecast of 5.3 percent real growth, economic expansion in the major foreign industrial countries this year is not expected to exceed last year's 3 percent rate.

In qualitative terms, the impact of the relatively strong U.S. cyclical position on our trade balance is quite clear: our strong recovery is leading directly to rapid increases in U.S. imports, while growth in our major export markets fails to keep pace. A ballpark estimate for the "growth gap" in our trade balance is $15 to $20 billion this year.

A slow recovery in the industrial world has not been the only problem for U.S. export markets. We are also a major exporter to developing countries -- and our trade performance has been strongly influenced by their debt problems over the past two years. The inability of these countries to finance previous levels of imports was the major reason for the 50 percent drop in U.S. exports to Mexico from 1981 to 1983, which I cited earlier, and for the $22 billion deterioration in our trade balance with all non-OPEC LDCs. Similar financial problems in Eastern Europe were reflected in a $1-1/2 billion decline in U.S. exports to that region, as well. Finally, while there is no way to quantify it, LDC debt problems have undoubtedly had an indirect negative effect on our exports to other industrial countries, by lowering their own exports and real growth. Overall, a ballpark estimate of the debt-related part of the widening of our trade deficit would be at least $25 to $30 billion.

Finally, a significant portion of the U.S. trade deficit was also attributable to the appreciation of the dollar on foreign exchange markets. Between the beginning of 1981 and this January, the dollar appreciated roughly 30 percent on a weighted-average basis against other major currencies. Although it has since depreciated somewhat, it takes roughly two years for the full impact of exchange rate changes to be evident in our trade balance. As a result, the exchange rates driving this year's trade deficit will still be mainly those of 1981-1983, when the dollar was appreciating.

Dollar appreciation, to the extent it is not offset by relatively better U.S. inflation performance or other factors which improve our competitiveness, makes it more difficult for U.S. businesses to compete with foreign firms. This is true both in our domestic market, where foreign goods become cheaper for U.S. consumers, and in our export markets, where dollar-priced goods become more expensive in terms of the local currency.

While there is general agreement on the direction of the impacts of exchange rate changes on trade flows, it is much more difficult to pinpoint the size of those impacts. There are a number of analytical techniques which can be applied to this issue, which yield significantly different estimates, and in addition small changes in the application of a given technique can produce large changes in the result. Estimates which attribute to dollar appreciation the residual part of the widening of our trade deficit -- the part which is not explained by relative growth rates or debt problems -- run as low as $25 billion for 1984. At the high end of the range are estimates from simple econometric models which reach as much as $100 billion. There are substantial technical problems with all methods of performing this calculation, and econometric models in particular have poor track records in predicting the impacts of large shifts in economic variables. The most we can say with any confidence is that the truth probably lies in the $25 to $100 billion range.

Exchange Rate Developments

There are many who would argue that, regardless of how large or small the impact of dollar appreciation actually is, it has been artificial and unhealthy. Thus, we are told that the dollar has been driven up unnecessarily by an excessive U.S. budget deficit and high U.S. interest rates. We are offered precise calculations of the degree to which the dollar is "overvalued" -- figures typically ranging from 20 to 30 percent.

On balance over the last three years, the dollar appreciated substantially against all major currencies -- yet interest rate differentials moved against the dollar. Between the beginning of 1981 and the end of last year:

-- the dollar appreciated by 38 percent against the German mark, 83 percent against the French franc, and 14 percent against the Japanese yen;

-- while interest rate differentials moved against dollar assets, by 5 percentage points for Germany, over 9 percentage points for France, and nearly 6 percentage points for Japan.

There is a similar pattern in the recent depreciation or the dollar. Since its mid-January peak:

-- the dollar has dropped 7 percent against the German mark, 6-1/2 percent against the French franc, 3 percent against the British pound, and 4 percent against the Japanese yen;

-- while interest rate differentials vis-a-vis all other major industrial countries have moved in favor of the United States.

A more meaningful economic argument can be made linking high real interest rate differentials with a strong dollar. It is notoriously difficult to measure real interest rates, given the central role played by inflation expectations in determining the real interest rates perceived by investors. Work we have done at Treasury suggests that there has been little correlation between movements in real interest rates and real exchange rates. However, all such empirical work is very sensitive to the means chosen to approximate expected inflation rates in the United States and the other major industrial countries, and it is possible to obtain a wide variety of differing estimates.

More fundamentally, both the appreciation of the dollar over the past three years, and its recent depreciation, reflect the normal working of the international adjustment process. The concept that the dollar has become "overvalued" is intuitively appealing, but a poor guide to economic policy. Most estimates of the degree of dollar "overvaluation" are based on the assumption that the exchange rate between any two countries should move only to offset differing national inflation rates, so as to keep the international price-competitiveness of traded goods unchanged.

Decades of economic research, however, have failed to verify this simplistic "purchasing power parity" theory of exchange rate determination. This should not be too surprising, since it is only designed to explain one dimension of the behavior of merchandise trade -- which in turn is only a small part of total international transactions. The vast bulk of transactions in the foreign exchange markets are capital transactions, and the dynamics of the foreign exchange market reflect that fact.

International investors act on their perceptions of where real after tax rates of return to capital will be highest, and they constantly weigh the relative attractiveness of assets denominated in different currencies. Thus, when investors sense that there are current or prospective developments which will significantly alter relative rates of return to capital, they react accordingly. Over time, the resulting international capital flows help to achieve a more efficient allocation of resources.

The major factors influencing market perceptions of real rates of return to capital over the past three years have been: fundamentally better U.S. economic performance and prospects; weaker performance and prospects in other major industrial countries; and the threat posed by economic and political turmoil in the Middle East, Latin America, and Eastern Europe. Our economic program brought a historic turnaround in U.S. inflation performance, followed by vigorous recovery. As a result of our non-inflationary recovery, deregulation, and more favorable depreciation allowances under the Economic Recovery Tax Act of 1981, the profitability of American business investment has improved dramatically. Foreign economic prospects and business conditions, especially in Europe, did not keep pace with ours. And in many troubled parts of the globe, concerns over possible expropriation, capital controls, or physical destruction of assets led to "safe haven" capital flows into the world's strongest and most stable country.

Under those circumstances, there was nothing we should -- or could -- have done to keep the dollar from appreciating, short of weakening our own economy to match the rest of the world. Similarly, we see no reason to be concerned about the recent orderly depreciation of the dollar. Several of the factors which have been pushing the dollar up are now shifting. International investors may be recognizing that the most rapid and dramatic improvements in the U.S. economy have already happened, and that many other industrial countries are catching up. Similarly, the historic turnaround in U.S. inflation performance has largely run its course for now, and we are entering a temporary period of slightly higher inflation rates. Finally, at some point currency depreciation in response to a widening current account deficit is a normal part of the international adjustment process. Over time, dollar depreciation should help to moderate both the U.S. trade and current account deficits and foreign surpluses.

Impacts on the U.S. and Global Economy

Despite occasional assertions to the contrary, a widening U.S. trade deficit has not been an unmitigated disaster for either the United States or for the rest of the world. For each there are both gains and losses, and trade developments cannot be judged in isolation from other economic developments and policies.

In the United States, there can be no question that firms in our traded-goods industries are finding life more difficult. Particularly as a result of dollar appreciation, they must cut costs (and in some cases profit margins) in order to compete with foreign goods in both our domestic market and in markets overseas. One result may be that the direct impact of the deficit will be to make output and employment in these industries lower than it otherwise might have been. However, it should be remembered that the widening trade deficit is, to a large extent, an indirect result of our success in cutting inflation and revitalizing the American economy. The benefits of our policies and our non-inflationary recovery have helped to offset negative impacts of a bigger trade deficit, not only for the economy as a whole but also for

traded-goods industries. Profit reports, stock market results, and productivity and employment gains in U.S. manufacturing industries do not seem to indicate a "deindustrialization" of America.

In addition, for American consumers as a group there are significant gains from a lower cost of imported goods, which leads directly to lower inflation and increased real buying power. Greater foreign competition impacts indirectly on our inflation rate, as well, by keeping the pressure on U.S. firms for lower costs, greater efficiency, and lower prices. Service industries, which compete primarily for domestic sales against other U.S. firms, reap the benefits of lower inflation and thus tend to have rising output and employment.

Some analysts have complained that the strong dollar and widening trade deficit are causing the current U.S. recovery to be "unbalanced" and therefore unsustainable. I don't think the facts support this claim. As indicated in Table 5, not only was our 6.2 percent real GNP growth rate during 1983 about in line with growth at the same stage of previous recoveries, but the pattern of that growth was healthy. Consumer spending (particularly durables purchases), housing, business investment, and even exports all made greater contributions to this recovery than in previous ones. Weaker than average contributions came from Federal, state and local government spending and from net exports. What is particularly striking is that interest-sensitive categories all made greater-than-average contributions to the recovery -- and that business investment, which is so crucial to sustained growth, is booming most of all.

For the rest of the world, the impacts of our trade deficit are in many ways a mirror image of impacts on the United States. Traded goods industries in other countries gain output and employment; there is also a temporary upward pressure on foreign inflation rates from higher import costs. Trade gains with the United States have probably been a significant factor in helping to solidify the hesitant economic recovery in Europe. In the longer term, improved trade balances in less developed countries are necessary to enable them to service their debt in an orderly manner, and for these improvements to take place there must inevitably be a counterpart swing towards deficit among their trading partners. Our widening deficit is thus clearly facilitating the economic adjustments which financially troubled developing countries must make to resolve their international debt problems.

The charge is sometimes made that a large U.S. trade and current account deficit causes the United States to "drain capital" out of the rest of the world, thereby damaging other countries. In balance of payments accounting, it is undeniably true that a current account deficit must be parallelled by transactions of equal size, and opposite sign, elsewhere in the balance of payments. These parallel transactions are usually thought of as being capital transactions,

so that a U.S. current account deficit by definition would mean there is also a net capital inflow to the United States.

There are a number of fundamental problems with the "draining capital" accusation, however. The first is the influence of the statistical discrepancy, as clearly reflected in U.S. capital account data for 1982 (Table 6). Our 1982 current account deficit of $11 billion might have implied an $11 billion net capital inflow, if there were no statistical discrepancy in our balance of payments. However, in fact there was a recorded net capital outflow of $30 billion in 1982, and the accounts were balanced by a positive statistical discrepancy of $41 billion. By definition, we do not know what sorts of transactions contributed to the discrepancy -- and while the possibilities for measurement error and reporting gaps are probably greatest in the capital account, the existence of a large discrepancy casts some doubt on all of our balance of payments data.

A second basic flaw in the "draining capital" argument can be seen in the 1983 data. Last year the statistical discrepancy was rather small ($7 billion), so our $41 billion current account deficit was reflected mainly in recorded net capital inflows, totaling $34 billion. However, the 1982-83 swing from net capital outflows to net inflows was not the result of higher inflows of foreign capital to the United States: these inflows actually fell by $5 billion, from $88 billion in 1982 to $83 billion last year. What caused a net inflow was that outflows of U.S. capital fell by even more -- by $69 billion. U.S. investors, and particularly U.S. banks, reduced their foreign lending dramatically, while foreigners also invested somewhat less in the United States.

The third flaw is the issue of causation. Since the balance of payments must, by definition, balance, a current account deficit can only occur in conjunction with a net capital inflow (disregarding the significant problem of the statistical discrepancy). However, one cannot legitimately say that the current account deficit "caused" the capital inflow. It would be just as easy -- and just as misleading -- to say that increased demand for U.S. dollar assets, as reflected in the capital account, has forced us to run a current account deficit. The fact is that all of the transactions recorded in our balance of payments accounts are simultaneous reflections of U.S. and foreign economic conditions, in the ways I have discussed earlier.

The U.S. Policy Response

As is probably clear by now, we do not believe that the widening trade deficit should precipitate major changes in U.S. economic policy. Some of the measures which are urged on us are impractical or even counterproductive. In addition, we believe that forces are already in motion -- both through government policy actions to strengthen foreign economic performance and manage debt problems, and through the working of the international adjustment process -- to address the major causes of our widening deficit.

One set of policy responses which we have consistently rejected is direct action to drive down the dollar's exchange market value. As was demonstrated by the thorough international study of foreign exchange market intervention carried out between the Versailles and Williamsburg Summits, intervention does not have a significant or lasting impact on exchange rates. Attempts to use intervention to permanently alter exchange rate levels are doomed to failure.

If intervention sales or purchases are done in such a way that they are permitted to alter the course of domestic monetary policy -- that is, if they are "unsterilized" in the technical jargon -- they can have a lasting impact. However, this can be a misleading way of looking at what is really going on in such a case: the factor which would alter exchange rate behavior would be that there had been a change in monetary policy, not that it had taken place in connection with intervention. There is no doubt that we could drive down the dollar very rapidly by reigniting rapid inflation through excessive money growth -- but I cannot seriously believe that the American people want to undo all we have done to bring inflation under control and revitalize our economy. Furthermore, while we would quickly reap the disastrous results of excessive monetary expansion in our domestic economy, the positive effects of dollar depreciation on our trade balance could take roughly two years to reach their full extent, as I noted earlier.

Some observers have suggested that we use capital controls to force down the dollar. I suspect even the proponents recognize that imposing capital controls would be a self-destructive act, and are only suggesting them for dramatic effect. In brief, I would note that capital controls the United States has tried to use in the past have not worked particularly well. More fundamentally, to the extent that new U.S. controls did work they would have major negative impacts on domestic and international capital markets, could lead to interest-rate increases and sectoral credit shortages, and would undermine the longer-term confidence of international investors in the U.S. dollar as a transactions currency and the U.S. economy as a place to invest.

There have been proposals over the past year to "correct" the U.S. trade deficit, and to modify the impact of foreign competition on U.S. industries, by restricting foreign access to the U.S. market or by subsidizing U.S. exports.

The push for market protection is not new. Protectionist pressures always increase in an economic recession, in response to increasing unemployment and reduced production at home. Once the domestic market has turned around and has begun to expand once more with economic recovery, we would logically expect these pressures to subside. But in practice, they usually don't. The reason: in the initial stages of recovery, imports often grow faster than exports, unless recovery is global and simultaneous.

The strong pace ot U.S. recovery, in advance of recovery in our major foreign markets, has increased demand for both domestic and foreign goods in the U.S. market. A surge in imports, per se, therefore, should not be read as damaging to competitive U.S. industries. As I noted earlier, the rise in imports is in large measure a reflection of successful U.S. policies and a non-inflationary recovery which is benefitting all American citizens and industries.

Protectionism is not cost-free by any means. Its drawbacks are clear and well known to you. But let me summarize them briefly. Protectionism can have a serious impact on other sectors of the U.S. economy through a general increase in inflation, higher prices to industries dependent on the protected imports, and the risk that the countries affected by the import restraints will retaliate.

These drawbacks certainly apply to surcharges or quotas imposed under the authority of Section 122 of the Trade Act of 1974. An import surcharge or quota would increase inflation, be likely to lead to retaliation by our allies, and cut the ground from under U.S. efforts to restrain protectionism by other countries. Such an outcome could deal a serious blow to the non-inflationary world recovery now developing.

A general surcharge, furthermore, might well be offset by a corresponding appreciation of the dollar, leaving our competitive position unchanged. Alternatively, under some circumstances it could be viewed as a reckless, panic reaction which could weaken confidence in the U.S. economy and U.S. leadership. In either event, use of Section 122 authority would be inappropriate and counterproductive.

While the United States did impose a surcharge on imports in 1971, the situation then was very different. In contrast with our current flexible rate system in which exchange rates adjust continuously to changing economic conditions, exchange rates in 1971 were fixed, and it was not possible to get serious negotiations underway despite the fact that rates were clearly out of line with the underlying fundamental economic situation in major countries. A dramatic measure was needed to begin serious negotiations on exchange realignment -- and the surcharge was subsequently removed within months.

Nevertheless, U.S. industries do have a legitimate right to seek redress from unfair foreign practices such as the use of subsidies benefitting exports and foreign dumping. This Administration will continue to actively enforce our countervailing duty and antidumping laws, as we have in the past.

Where individual industries are being hurt by surging imports, they can request import relief under our trade laws. Several cases are now pending under these provisions. They will be decided on their merits on a case-by-case basis.

On the export side, the Administration has been concerned about the impact of foreign export subsidies, especially in the agricultural area, on our ability to compete in third markets. We have directly subsidized exports to individual markets such as Egypt to bring this point home and are working both bilaterally with the European Community and multilaterally within the GATT. We are prepared to continue such selected subsidies, as necessary.

However, we do not see a need for broad export subsidies for all U.S. exports, to "offset" the impact of the strong dollar. Such subsidies would be extremely costly to the Treasury at a time when we need to sharply reduce Government expenditures. They could spur foreign imposition of countervailing duties. And they could set off an escalation of disruptive trade competition that will benefit no one.

In conclusion, I would urge the Congress to resist pressures to respond to the widening of our trade deficit with measures which would be harmful to our own broader national welfare. While it is unfortunate that impacts of increased competitive pressures from foreign goods are not always as evenly distributed among our citizens as are the benefits of our non-inflationary recovery, we must remember that the deficit is, to a large extent, an indirect result of our success in revitalizing the American economy.

As economic recovery abroad catches up with our own, as developing countries come more fully to grips with their debt problems, and as the international adjustment process brings an exchange market response to diverging external positions among the major industrial countries, we expect the deficit to begin declining again over time. In the meanwhile, we will continue to fight unfair foreign trade practices such as subsidies and dumping. In addition, where there are restrictions on access by U.S. firms to foreign markets for goods, services, or capital, we will continue to press for a more open system.

Table 1

U.S. Trade Balance, 1977-1984*
($ Billions)

	1977-1982 Average	1982	1983	1984**
Exports	187	211	200	205
Imports	-217	-248	-261	-305
Balance	-30	- 36	-61	-100

* Trade data on balance of payments basis.
** Treasury projection for 1984.

Table 2

Shifts in U.S. Trade by
Country or Country Group, 1981-1983*
($ Billion)

	1981	1983	Shift
Trade with Mexico:			
U.S. Exports	18.2	9.1	-9.1
U.S. Imports	-13.8	-16.8	-3.0
Balance	4.4	-7.7	-12.1
Trade with Other non-OPEC LDCs:*			
U.S. Exports	49.7	46.4	- 3.3
U.S. Imports	-53.1	-60.4	- 7.3
Balance	- 3.5	-14.1	-10.6
Trade with Japan:			
U.S. Exports	21.8	21.7	-0.1
U.S. Imports	-37.6	-41.3	-3.7
Balance	-15.8	-19.6	-3.8
Trade with Other Industrial Countries:			
U.S. Exports	120.1	105.3	-14.8
U.S. Imports	-106.7	-113.0	- 6.3
Balance	13.4	-7.8	-21.1
Trade with East Europe			
U.S. Exports	4.4	2.9	- 1.5
U.S. Imports	- 1.6	- 1.4	0.2
Balance	2.9	1.5	- 1.3
Trade with OPEC			
U.S. Exports	21.1	15.1	- 5.9
U.S. Imports	- 49.9	- 25.2	24.7
Balance	- 28.8	- 10.0	18.8

*All data on balance of payments basis, except trade with "other non-OPEC LDCs" which is on roughly-comparable Census Customs-value basis.

TABLE 3

U.S. Trade and Current Account Balances, 1981-1983
($ Billion)

		1981	1983	Shift
Exports:	Agricultural	44.0	36.6	- 7.4
	Non-Agricultural	193.0	163.6	-29.4
Imports:	Oil	- 77.8	- 53.8	24.0
	Non-Oil	-187.3	-206.9	-19.7
TRADE BALANCE		- 28.1	- 60.6	-32.5
Net Investment Income		33.5	23.6	- 9.9
Other Net Services		6.1	4.8	- 1.3
Net Transfers		-6.9	- 8.6	- 1.7
NET INVISIBLES		32.7	19.8	-12.9
CURRENT ACCOUNT BALANCE		4.6	- 40.8	-45.4

Table 4

Shifts in U.S. Trade Balance, 1981-1984
($ Billion; Balance of Payments Signs)

	1981	1984	Change
Exports	237	205	- 32
Oil Imports	- 78	0	+ 18
Non-Oil Imports	-187	-245	- 58
TRADE BALANCE	- 28	-100	- 72
Trade Balance Excluding Oil Imports	50	- 40	- 90

Estimates of Contributions to Shift in Trade Balance:

U.S. Cyclical Position	-15 to -20
International Debt Problem	-25 to -30
Dollar Appreciation	-25 to -100

Table 5

THE BALANCED NATURE OF THE CURRENT EXPANSION

As the table shows, the current expansion has been remarkably well balanced, rather than distorted by high interest rates as some had feared. Above-normal gains have been made in the interest-sensitive areas of spending on consumer durables such as autos and appliances, as well as in business capital spending and housing. The trade balance has been weak but exports have risen rather than remaining flat as in the first year of the average of previous expansions.

Distribution of Real GNP Growth During
the First Year of Expansion
(as percent of total)

	Average of five previous expansions	Current expansion
Consumer Spending	52.3	57.3
Durables	19.3	24.0
Business Capital Spending	7.6	21.9
Housing	15.2	16.6
Inventories	26.4	34.2
Federal Purchases	-2.8	-8.7
State and Local Purchases	7.5	0.8
Net Exports	-6.0	-21.9
Exports	0.6	4.5
Imports	-6.4	-26.5
Memo: Total growth in real GNP in percent	6.8	6.2

Table 6

U.S. Capital Account, 1982-1983
($ Billion)

	1982	1983
Recorded Inflows of Foreign Capital to U.S.	88	83
minus		
Recorded Flows of U.S. Capital to Other Countries	-118	- 49
equals		
Net Recorded Capital	- 30	34
plus		
Statistical Discrepancy	41	7
equals		
Net Recorded Capital plus Discrepancy	11	41
Current Account Deficit	-11	-41

Chart 2

SHIFTS IN U.S. TRADE BALANCE BY COUNTRY OR COUNTRY GROUP, 1981-1983

($ Billion)

U.S. Trade Partner	1981-83 Trade Shift
Japan	—4
Other Industrial Countries	—21
Mexico	—12
Other Non-OPEC LDC's	—10
Eastern Europe	—1½
OPEC	+19

Chart 3

FACTORS INFLUENCING TRADE BALANCE

Factors Increasing Trade Deficit

● Strong, early U.S. recovery	$15 to $20 billion
● Slower, weaker recovery abroad	
● LDC debt problem	$25 to $30 billion
● Dollar appreciation	$25 to $100 billion

Factors Reducing Trade Deficit

- Improved U.S. competitiveness
- Foreign recovery
- Resolution of debt problem
- Dollar depreciation
- Opening up foreign markets for goods, services, and capital

Chart 7

THE BALANCED U.S. RECOVERY

	Percentage contributions to first-year growth:	
	Average of five previous expansions	Current expansion
Consumer Spending	52.3	57.3
Durables	19.3	24.0
Business Capital Spending	7.6	21.9
Housing	15.2	16.6
Inventories	26.4	34.2
Federal Purchases	−2.8	−8.7
State and Local Purchases	7.5	0.8
Net Exports	−6.0	−21.9
Exports	0.6	4.5
Imports	−6.4	−26.5
Memo: Total growth in real GNP in percent	6.8	6.2

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The CHAIRMAN. Fred.

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Mr. BERGSTEN. Mr. Chairman, thank you very much.

In the interests of time, I will try to make brief statements in summarizing the paper that I gave you.

The first is to say that, in some sense, it is even worse than you think. On my projection, the trade deficit as of this year will hit $120 billion and the current account deficit about $100 billion. It's going to get worse, not better, in 1985. The trade deficit could hit as high as $150 billion, and this would take the current account up to as much as $125 billion. So it is clearly getting worse.

The result of that would be something like 3 million Americans out of work by the end of next year as a result of the trade deterioration, and clearly the United States moving—as Senator Long and others have referred to—into big net debtor status. On my projections, by 1986 the U.S. net foreign debt position would be equal to that of Mexico and Brazil today. That's not as serious as it sounds on first blush—obviously, our economy is larger and stronger—but it is a radical shift in the whole international financial position of this country.

One direct implication has already been referred to: we would lose the big earnings we have had on our investment position abroad, which has exceeded $30 billion as recently as a couple of years ago. That would all disappear. That takes a full percentage point off our GNP, and is a major factor.

So, it is bad. It is getting worse. There is no light at the end of the tunnel that one can now see under current policy or trends, at least out through 1985, 1986, and really as far ahead as the eye can see.

Second, why is all this? I wouldn't differ from the three-way breakdown that Tim McNamar and others have suggested, except to say that I believe the dollar overvaluation can be quantified and is a much bigger factor than suggested.

The dollar has risen by at least 30 percent in trade-weighted terms over the last 3 years. There is a pretty good rule of thumb, historically, that every percentage point loss of price competitiveness costs our trade balance $2.5 to $3 billion. So the rise in the dollar would have accounted for somewhere between $75 and $90 billion of deterioration, on that analysis, putting it up toward the top of Secretary McNamar's range as a factor causing the overall problem.

Perhaps more importantly, in terms of what you can do something about, it's by far the most important one. We are not going to slow down our economy in order to have a slower growth of imports relative to the rest of the world; we are obviously not going to try to undermine the safe-haven appeal of our country or our economy; so those other factors that have strengthened the dollar and lead to a deterioration of our trade balance are not something we want to do anything about. The one thing we can and should do something about is the excessive pricing of our currency, which gets back, then, to the trade deficits and interest rates.

Third, and finally, what to do about it?

I would share the consensus and take the opportunity to praise the work of this committee, as others have done. The critical thing is decisive, fundamental, credible action on the budget deficit. You have taken your steps in that direction. They can only be applauded and cheered on. That is, critically, the first and most important thing to do.

However, if it is not going to be done enough or lastingly enough, with the rest of the Congress and the President not coming along, then one can't just quit and say "Nothing else to do." And there, despite my support for Marty Feldstein on the macropolicies, I would strongly disagree that at that point you should just quit, because there are other things you can and should do about the exchange rate.

For example, there have been three episodes in the last year and a half—the most recent just a few weeks ago—when the market itself was beginning to produce some correction: the yen was rising, the mark was rising, the dollar was correcting. In my view, the central banks of those major countries should at that point have come into the market, and supported the market trend which was moving toward correction by intervening directly in the markets. That is called in the jargon "leaning with the wind" in the exchange markets, rather than the traditional approach of "leaning against the wind." Instead of letting the corrective movement stall out and reverse, as now may even be happening again because the dollar has been rising again in the last 2 weeks, you should come in, take advantage of a market move in the right direction, and push it.

Second, it may be that we are going to have to have direct action to interfere with some of these international capital flows, which, as pointed out, are distorting the competitive-position relationship through the exchange rate.

I always have to be very careful when I say the dollar is overvalued, particularly when I am on a panel with Tim McNamar, to say what I mean. What I mean is that the dollar is overvalued compared with the underlying competitive relationships of the U.S. economy vis-a-vis the economies of Japan, Germany, other major countries. And I think that means something ought to be done about it.

One thing to do about it is to intervene directly to affect the capital flows. The United States, as you all recall, did that back in the 1960's when we were in the boat of having trade surpluses more than offset by capital outflows due to higher interest rates at that time in the rest of the world. We put on an interest-equalization tax, and we did other things to try to correct it.

I don't hold those up as panaceas—they are not very desirable. I wish we could do the better things first; but if we can't, some action of that type might be desirable.

Finally, something I would not do—and here I join the consensus this morning—is an import surcharge. I won't argue theology, I'll just argue practicality. I think, Mr. Chairman and Senator Long, an import surcharge would not work in today's world of flexible exchange rates.

All the examples you mentioned, Mr. Chairman, of import surcharges being used in the past occurred under fixed exchange rates. And likewise, the U.S. import surcharge in 1971 occurred under fixed exchange rates. And under that condition, they might possibly have some limited benefit.

But under flexible exchange rates, if you put on an import surcharge, everybody would believe that both its purpose and its effect would be to strengthen the trade balance. But if you strengthened the trade balance, that would tend to strengthen your currency further. And you can actually show, theoretically, that the net effect of putting on an import surcharge or other trade controls would lead to an offsetting rise in value of your currency, which would intensify the overvaluation problem you have got and lead to a net balancing out, so that the trade balance as a whole would not gain. There would be some distributional shifts; exporters would be particularly hurt, of course, because importers would be protected; the dollar would rise and the exporters, who weren't getting any new subsidy would be put in an even worse position than they are today.

So the whole thing would tend to net out, and you wouldn't be likely to get any net improvement in your external position under flexible exchange rates.

In addition, I would echo the point made by others, that for the United States at this point in time to take a step of that type would almost certainly lead to a massive disruption of the international trading system. The United States, recall, is the only industrial country in the world which is experiencing a substantial economic recovery and a decline in unemployment. If we, the only successful economy, were to put on trade controls, clearly the other countries who are struggling much more than we could only retaliate in kind, given their internal politics.

So, I think on that ground it would be a disruptive step. That one, I would counsel against.

Thank you very much.

[Mr. Bergsten's prepared statement follows:]

THE CAUSES AND CONSEQUENCES OF THE UNITED STATES TRADE DEFICIT

Statement by C. Fred Bergsten
Director
Institute for International Economics

Before the
Committee on Finance
United States Senate
March 23, 1984

Summary

The outlook for the international trade (and financial) position of the United States is shocking:

-- In 1984, the merchandise trade deficit will probably hit $120 billion and the current account deficit could approach $100 billion.

-- In 1985, the trade deficit could reach $150 billion and the current account deficit about $125 billion.

-- As a result, as many as three million Americans will be unemployed solely as a result of the deterioration in our external accounts.

-- Moreover, the specter of continuing trade deficits (and the dollar overvaluation which largely spawns them) is inducing major US firms to contemplate investment abroad rather than at home, as occurred on a massive scale during the last major period of dollar overvaluation (late 1960s - early 1970s), with the attendant risk of substantial deindustrialization of our economy.

-- In addition, as a result of the massive net capital inflows needed to finance these deficits, the United States by 1986 will clearly owe more to foreign nations than the value of its own investments abroad--becoming a net debtor nation for the first time since World War I, and probably approaching the present debt level of Mexico and Brazil in absolute terms.

-- This reversal of America's international investment position will eliminate much or all of the annual net inflow of investment income to the United States, which peaked at over $33 billion in 1981 and has been a major source of strength of our current account for decades--which, in turn, will require an even greater improvement in the merchandise trade balance to restore current account equilibrium.

-- These problems can be resolved only through correction of the massive overvaluation of the dollar, now about 25 percent as recognized publicly even by some in the Administration. In addition to causing most of the huge trade deficits, continued dollar overvaluation is a major source of pressure for protectionist trade measures and (as also noted above) is also forcing major American firms to contemplate investing abroad rather than domestically.

-- To help correct the currency misalignment, the monetary authorities of the United States and other major countries should have been intervening jointly in the

exchange markets in recent weeks to sustain and accelerate the strengthening of the yen and European currencies that was occurring, as they should have during the similar corrective movements of late 1982 and fall 1983 which stalled out and subsequently were reversed. In such circumstances, the authorities should replace the traditional intervention criterion of "leaning against the wind" to "lean with the wind" in the direction of underlying equilibrium.

-- To assure lasting dollar correction, however, urgent action to substantially reduce the budget deficit and thus US interest rates--which draw large amounts of capital into the dollar--is required.

-- In the absence of such steps, and perhaps even in addition, direct action to alter international capital flows may be needed. As other nations share the US interest in correcting the currency misalignment, the most feasible remedy is probably for the major capital-exporting countries (Japan and Europe as a group) to install interest equalization taxes or limits their outflows temporarily through direct controls.

-- It would be a mistake to apply an import surcharge as a corrective device, as envisaged in Section 122 of the Trade Act of 1974. Under floating exchange rates, such a step could well lead to a further strengthening of the dollar--which would further harm US exports and offset the gains from the surcharge--in response to market

expectations of those gains. In addition, any such act by the United States--the only industrial country in the world which has recovered rapidly from the recession and where unemployment is falling sharply--would clearly trigger major retaliation from abroad, perhaps destroying the relatively open trading system and detonating the "debt bomb."

The Trade Outlook for 1984

The US merchandise trade deficit reached an annual rate of about $75 billion in the fourth quarter of 1983. For the year 1983 as a whole, the deterioration in real net exports of goods and services retarded the recovery by a full 25 percent--bringing it in at 3.3 percent rather than the 4.4 percent (year-over-year) which would have occurred with an unchanged trade balance.

In 1984, substantial continued deterioration is certain. First, the dollar has until very recently continued to reach new highs in the exchange markets and is now overvalued--relative to underlying competitive positions--by about 25 percent.[1] This is the equivalent of placing a 25 percent tax on all US exports and paying a subsidy of 25 percent on all imports coming into the United States. Every percentage point deterioration in US price competitiveness costs our trade balance $2-3 billion over the coming 1-2 years. Hence at least $10-15 billion of additional loss stems from the further dollar strength of late 1983.

1. For the methodology and detailed calculations, see John Williamson, The Exchange Rate System (Washington: Institute for International Economics, September 1983).

Second, the United States seems likely to continue growing faster than all other major countries in 1984 (for an unprecedented second straight year). DRI projects the United States at 5.3 percent and the rest of the world at about 3.5 percent, while Project LINK has the United States at 5.9 percent and the rest of the OECD at only 3.8 percent. This means that US demand for imports will be growing much faster than foreign demand for US exports.

In addition, the US income elasticity of demand for imports is substantially higher than that abroad. US imports now tend to grow about 50 percent faster, compared with our GNP growth, as do imports abroad. So the continuing "growth gap" will add at least $20 billion more to our trade balance deterioration.

Three other factors could affect the outlook. There should be a modest pickup in the imports of some debt-ridden developing countries, such as Mexico, which will help US exports. Our terms of trade could continue to improve, as happened--due mainly to the strong dollar itself--throughout 1981-83 (masking much of the deterioration in our real trade balance). But the long-anticipated fall in the dollar, if it materializes in 1984, could have the opposite effect instead; even a 10 percent fall in the dollar could, in the first instance, add as much as $10-15 billion to the trade deficit.[2]

2. As a result of familiar J-curve effects, assuming a 50 percent price passthrough.

The most likely outcome for 1984 is thus a merchandise deficit of about $120 billion--a bit larger than the $110 billion forecast in the recent Annual Report of the Council of Economic Advisers (page 43).[3] The January deficit has already come in at an annual rate of about $100 billion (with imports valued on an f.o.b. basis), more than midway from the fourth quarter rate to my projection for 1984 as a whole.

This will in turn take the current account deficit to about $100 billion. The surplus on services and unilateral transfers, which reached as high as $33 billion in 1981, is declining sharply primarily because of our interest payments on the massive buildup of foreign investments here which are financing the current account deficit. This surplus fell to about $25 billion in 1982 and the first three quarters of 1983. It could well dip to $20 billion in 1984, even taking into account some increase in our direct investment earnings because of a pickup in economies abroad, and take the current account deficit to nearly $100 billion.

It is particularly tricky to try to convert these trade numbers into their GNP equivalents, but an outcome as described could take 1 1/2-2 percentage points off economic growth in 1984. The deterioration of about $100 billion from 1981 to 1984

3. And hitting the 12-digit level which, I believe alone, I began forecasting in late 1981 and throughout 1982. See my "The Costs of Reaganomics," Foreign Policy (Fall 1981) pp. 28-29, and "The International Implications of Reaganomics," Kieler Vorträge, no. 96, February 18, 1982. Both are reprinted in the The United States in the World Economy: Selected Papers of C. Fred Bergsten 1981-1982, Lexington, Mass.: D.C. Heath and Co., 1983.

means that by the end of this year there will be about 2 1/2 million unemployed workers--about three-quarters of them in manufacturing[4]--who could otherwise have found jobs. The unemployment rate, correspondingly, will be about two percentage points higher than otherwise.

Further Deterioration in 1985

Contrary to the assertions of some Administration officials, the trade deterioration is virtually certain to continue at least into 1985. The pace of the deterioration, however, barring a further sharp rise in the dollar this year, is unlikely to be as great as in 1981-84.

The same factors as in 1984 suggest this outcome. The trade impact of the late 1983 surge in the dollar will continue into 1985, in view of the time lags involved. Moreover, the "growth gap" is likely to continue--DRI and Project LINK see US growth at about 3 1/2 percent, compared with 3 percent or less for the rest of the world. By then, a lower dollar is very likely--with adverse J-curve effects for a while.

Quantitative forecasts are obviously less certain as the forecast period recedes into the future, but the merchandise deficit could easily approach $150 billion in 1985. The current account deficit would then be at least $125 billion. Enough additional job loss would occur to take the cumulative total, from 1981, to beyond three million.

4. Data Resources, Inc., The DRI Report on US Manufacturing Industries (January 1984), p. 65.

The situation beyond 1985 will depend on the further course of the two variables emphasized: (1) if, when and by how much the currency misalignment is corrected, and (2) if, when and by how much the "growth gap" between the United States and other major countries is narrowed or reversed. Recall, however, that our real net exports deteriorated sharply throughout the recession of 1981-82--in fact, equalling about 75 percent of the total fall in real GNP. Hence the inevitable slowdown in US expansion need not, by itself and without the needed exchange-rate realignment, improve the trade balance to any significant extent. DRI has forecast a continuing deterioration of the US current account, albeit at lower levels than my own forecasts, through 1986 despite a decline in US growth below that of the other industrial countries in that year.[5]

Deindustrialization?

Beyond the trade deficits themselves, dollar overvaluation poses a growing threat to future investment in US plant and equipment. A large segment of American industry, running as high as 60-75 percent on some estimates, must now compete actively with firms based abroad either in world markets or here at home. Yet many of these firms are increasingly aware that the huge price disadvantage caused by dollar overvaluation may persist well into the future, if no action is taken to deal with the underlying cause of the problem--the budget deficit.

5. Data Resources, US Review (January 1984), table 7.4.

Some firms are therefore beginning to question the wisdom of future investment in the United States. Continued sizable dollar overvaluation would be likely to force them to invest abroad instead, not from any "runaway plant" mentality but simply for self-preservation, particularly because their foreign competitors are enjoying such huge profits and may be reaping irreversible competitive gains. Indeed, massive foreign direct investment was one result of the last prolonged period of dollar overvaluation in the late 1960s and early 1970s.[6] Such a shift would of course further reduce job opportunitites in the United States. In addition to jeopardizing the sustainability of the present recovery, this phenomenon is probably the greatest present cause for concern over any future "deindustrialization" of our economy.

Protectionism

The history of US trade policy throughout the postwar period reveals that dollar overvaluation, even more than aggregate unemployment, is the most reliable "leading indicator" of protectionist trade pressure in this country.[7] The reason is clear: dollar overvaluation badly jeopardizes the competitive

6. There were of course other major reasons for the expansion of foreign direct investment by US-based firms during that period. However, the buildup correlates almost precisely with the growing dollar overvaluation and, given the inherent lags in corporate planning, so did its slowdown from the mid-1970s (after the dollar devaluations of 1971-73). Likewise, investment in the United States by foreign-based firms was small prior to those currency corrections but has expanded rapidly since then.

7. C. Fred Bergsten and John Williamson, "Exchange Rates and Trade Policy," in William R. Cline, editor, Trade Policy in the 1980s, Washington: Institute for International Economics, November 1983.

position of even our healthy import-competing industries, as well as those which are traditionally vulnerable. Hence the coalition which seeks import relief is broadened substantially. The latest evidence is the adoption by the current Administration, despite its philosophical devotion to open markets and free trade, of major protectionist steps in at least a half dozen industries to date (autos, textiles/apparel, steel, sugar, motorcycles, and specialty steel). Indeed, major new trade controls were adopted in 1983 despite the dramatic decline in the aggregate rate of unemployment.

These pressures could become particularly intense in 1984 and 1985. As noted, the trade deficit will soar to $100-150 billion. Unemployment, though down sharply, will still be high--a great deal of it directly traceable to trade--and could begin rising again within the next 12-18 months. The election campaign will generate intense pressures to support additional import relief.

Continued dollar overvaluation would undermine the traditional case for open trade, in part because the benefits of such trade would be skewed heavily against the United States. Indeed, Section 122 of the Trade Act of 1974 authorizes use of an import surcharge "to deal with large and serious United States balance of payments deficits."

Under flexible exchange rates, however, an import surcharge could well be ineffective or even counterproductive. As soon as it was implemented, the markets would expect a consequent improvement in the US trade balance. As a result, the exchange

rate of the dollar could be expected to strengthen. (Evidence for this effect is provided by the episodic weakening of the yen over the past few years on news concerning possible new controls, in Europe as well as the United States, against Japanese exports.) Indeed, theory would suggest that the further overvaluation of our currency would fully offset the impact of the additional tariff.[8] Without necessarily trying to be so precise, it seems clear that our overall trade balance would gain little if any from an import surcharge offset by induced dollar appreciation--as exporters were hurt substantially and import-competing firms and workers were helped much less net than gross.

Moreover, any adoption of such a major protectionist device by the United States at this time could topple the open trading system which has been so crucial to postwar prosperity. Europe, with its much higher level of unemployment and structural economic woes, would almost certainly reply in kind (or worse). The developing countries, seeing the evaporation of their only hope to earn their way out of the debt crisis, would tighten their own trade controls further (and might even be pushed over the brink to massive moratoria and/or defaults). The damage to the world economy, from adoption of a major restrictive step by the only industrial country which is enjoying substantial

8. B. J. Eichengreen, "A Dynamic Model of Tariffs, Output and Employment Under Flexible Exchange Rates," Journal of International Economics, August 1981. In fact, Eichengreen concludes that increasing tariffs under flexible exchange rates, while it might create a modest number of jobs in the short run, would over time be likely to have a negative net impact on the level of employment.

recovery and declining unemployment, would be all too reminiscent of the 1930s and could take years (or decades) to repair.

A "Stabilization Crisis"?

One other possibility, recently outlined by my colleague Stephen Marris, is that the trade deficit itself, along with a failure to deal with the budget deficits and fears of renewed inflation, will produce such a precipitous fall in the exchange rate of the dollar as to have major adverse consequences for our economy.[9] Such a fall would come from a sharp reversal in capital flows, stemming from a collapse of international confidence in the sustainability of the American situation, which would then push US interest rates up both directly and--because the Federal Reserve might have to tighten money to stem the run on the dollar--indirectly.

Moreover, a sharp decline in the dollar would add significantly to inflationary pressures in the economy: a fall of 25 percent in the exchange rate would add three to four percentage points to the price level.[10] As a result, the United States would for a while get the worst of all worlds from its external accounts: a continued huge trade deficit, because of

9. Stephen Marris, "Crisis Ahead for the Dollar," Fortune, December 26, 1983.

10. The correction in the exchange rate of the dollar which is needed, as noted above, would of course also produce such an effect--but in a more orderly way over a longer period of time. Indeed, the inevitable upward push in the CPI from dollar depreciation--which, it should be noted, does not affect the "core" or "underlying" inflation rate--is better taken now than later, given the continuing low level of recorded inflation, thus adding to the urgency of restoring dollar equilibrium.

previous dollar overvaluation, and then higher interest rates and new inflationary pressures as well from a rapid fall of the currency. Again, urgent action is required--to begin the adjustment process soon enough, primarily through action on the budget deficit, to foster the needed currency correction in a relatively smooth manner, without a "free fall" à la 1978 and the enhanced risk of overshooting to an excessively weak (and inflationary) dollar once again.

The United States as a Debtor Country

One well-known component of this scenario is a huge net inflow of capital into the United States to finance the current account deficits. It is not widely recognized, however, that the magnitude of this flow seems certain to convert the United States in only three years into a debtor nation--for the first time since World War I, reversing the 65-year buildup of our position as an international creditor country.

The cumulative current account deficits for 1983-85, as projected here, exceed $250 billion. At the end of 1982, the net US creditor position was only $168 billion. Hence that position could be virtually wiped out by the end of this year, and seems certain to disappear during 1985.[11]

Two statistical caveats are worth noting. On the one hand, US assets abroad consist much more heavily of direct investment

11. The latest annual report of the Council of Economic Advisers, p. 57, agrees that the United States will probably move into net debtor status "sometime in 1985." Paul Volcker has testified to the same point on several recent occasions.

($221 billion, end-1982) than do foreign assets here ($102 billion). Since direct investment is calculated at book rather than market value, and since the stock of US direct investment abroad is considerably older on average than the stock of foreign direct investment here, our net creditor position on that account is probably understated.

On the other hand, the extent of foreign capital flow to the United States in recent years has almost certainly been significantly understated. During 1978-82, the US accounts include an unrecorded inflow ("statistical discrepancy" or "errors and omissions") which cumulates to over $130 billion. Some of this could be unrecorded exports of services, but "the discrepancy was probably in large part accounted for by unrecorded capital inflows."[12] Hence, if anything, the official data today probably overstate rather than understate the US international creditor position--reducing the base from which its reversal is now underway.[13]

Thus the United States seems destined, in the course of only three years, to offset the buildup of net assets abroad which

12. Survey of Current Business, August 1983, p. 43, in explaining the anomalous further rise in the US international creditor position in 1982 despite a current account deficit of $11 billion. No such anomaly is conceivable in 1983-85, however, because of the much larger magnitude of the current account deficit. Moreover, the "statistical discrepancy" seems to have disappeared in the second and third quarters of 1983.

13. A third caveat is that valuation adjustments, such as the recent sharp rise in value of US stocks and bonds, also affect the international balance sheet of the United States in ways not related directly to the current account position.

began during World War I. We would thereby return to our 19th-century status as a debtor nation, when we were a developing country.[14] Indeed, the magnitudes indicated by this analysis suggest that the United States could be challenging Brazil and Mexico for ranking as the top debtor nation in the world by 1986.[15]

There are numerous implications which stem from this prospective shift of the richest country in the world to debtor status. One is the huge misallocation of world resources which is suggested. Another is increased vulnerability for the dollar; my earlier studies show that the dollar crises of the 1960s and early 1970s were all associated with a decline of key US "liquidity ratios"--the relationship between our reserve assets and foreign dollar holdings, on various definitions[16]--below 100

14. The United States was still a net debtor, to the tune of $3.7 billion, in 1914 but had moved to creditor status of a similar magnitude by 1919. See Hal B. Lary, The United States in the World Economy, Department of Commerce, 1943, pp. 122-24.

15. Net external debt of both Brazil and Mexico will probably approximate $100 billion in 1986, as would that of the United States with the level of current account deficits suggested here. However, the debt-to-export ratio of the United States, at about 40 percent, would be much more like that of Hungary, Romania and Thailand than Brazil and Mexico (over 200 percent even after substantial improvement by 1986). For the LDC numbers see William R. Cline, International Debt and the Stability of the World Economy (Washington: Institute for International Economics, September 1983), pp. 54-55, 132.

16. C. Fred Bergsten, The Dilemmas of the Dollar: The Economics and Politics of US International Monetary Policy (New York: New York University Press, for the Council on Foreign Relations, 1975), esp. pp. 148-152.

percent, and a shift to net debtor status could be expected to have at least as much impact.

One very practical effect of this shift is that the US current account will no longer benefit from net earnings on foreign investment--because the foreign investment account will be in deficit rather than surplus. Our net investment income peaked at over $33 billion in 1981, but has already dropped by $6 billion in 1982 and by $3-4 billion more (annual rate) in the first three quarters of 1983. As we service the huge buildup of foreign holdings here, the remaining surplus will decline precipitously and perhaps disappear by 1986--even taking account of the higher return on US assets abroad because of direct investment's greater share in them.

This in turn means that the United States will no longer be able to offset, via a services surplus, a merchandise trade deficit of $25-30 billion. Hence the required improvement in the trade balance, from the massive level of deficit to which it is now soaring, is even greater than it would have been in the early 1980s to achieve equilibrium in the overall current account.

What to Do

Even if one were to quarrel with the precise magnitude of these estimates, it is hard to escape the overall conclusion: that the United States is now experiencing a massive, historically unprecedented erosion of its international trade and financial position. Moreover, given the time lags involved and policies now in place, it is too late to change the picture much for 1984 and it is getting late to do so for 1985. Nevertheless,

the outlook is so dire--and the likelihood so uncertain of achieving the needed correction in a healthy manner, if at all, under present policies--that the case for early action seems compelling.

Of course, the dollar recently declined a bit in the exchange markets and, as noted above, could fall rapidly as a result of the US trade and current account deficits themselves, along with continued failure to resolve the budget problem. US capital outflows, which fell sharply in 1983, may accelerate again as economic recovery picks up abroad. A renewed outbreak of inflationary expectations here could--most unfortunately, in this instance--promote correction of the dollar, as could the (also unfortunate) adoption of new stabilization measures (including higher interest rates) by other key currency countries.

None of these developments can be accorded a high probability, however, and the last mentioned--dollar correction via renewed inflation expectation--would raise major problems of its own. Moreover, as emphasized throughout these remarks, the situation is getting steadily worse. Decisive action to reduce the budget deficits (and hence interest rates) thus remains the most critically needed step to resolve our external problems (as well as central internal problems). Failing such action, however, it may be necessary to adopt "second best" measures aimed directly at the proximate source of the problem: the capital flows which are swamping the trade and current account balances and prompting exchange-rate relationships which are so at variance with underlying competitive realities.

In this context, there was a recent opportunity to improve the situation. During February and early March, the DM (and other European currencies) moved up sharply against the dollar. The yen joined the move in early March as well. As in two earlier cases when the yen moved up strongly (late 1982 and fall 1983), serious joint intervention by the United States and the countries whose currencies were rising--building on the market swing--could have intensified its speed and extent and perhaps assured that it would, at last, represent the permanent turning of the tide that is needed. The central banks would obviously have to be careful that they did not trigger an excessive ("bandwagon") move, and be ready to change course if that seemed to be occurring, but the failure to act in the face of excessive dollar strength over the past three years has clearly been a mistake.

Since no action was taken in the past few weeks, however, the reversal once again appears to have stalled out or reversed itself, representing merely another false start with no lasting impact. The need here is to reverse the existing thrust of intervention policy: to "lean with the wind" when it is blowing toward underlying equilibrium, rather than always "leaning against the wind" to smooth short-run market turbulence (or abstaining from engagement altogether).

In considering how to manipulate capital flows on a more lasting basis, if that turns out to be necessary, it is important to recognize that many other nations are also being hurt by the nexus of high US interest rates and dollar overvaluation. To be

sure, their trade balances gain as the United States suffers the massive trade deterioration just described. But this effect, for most countries, is probably more than offset by the depressing effect of high US interest rates on domestic demand within their borders.

In fact, most other countries cannot now use monetary policy to promote economic recovery. For example, Germany raised its key interest rate in September 1983 despite the very modest growth of its economy. Japan, to avoid further weakening of the yen and intensified protectionist reactions, has for over two years kept its interest rates at least two percentage points higher than called for by domestic conditions. Most of these same countries are also determined to tighten their budgetary policies, for long-run reasons of fiscal prudence and judgments concerning more immediate confidence and supply-side effects. The result is that most major countries--including Japan, Germany and the United Kingdom--have no policy tools available to promote acceptable rates of expansion.

In addition, all countries suffer from the intensification of the global debt crisis caused by dollar overvaluation and high US interest rates. And the protectionist pressures which are greatly intensified in the United States by dollar overvaluation, and threaten to block some of the export expansion which others could enjoy due to their currency undervaluations, are also a major source of concern abroad.

All countries thus have a major interest in launching steps to correct the situation. This interest has recently been

manifest in the calls of the French Minister of Economy, Finance and Budget, the architect of his country's quite orthodox austerity program, and the Social Democratic Party in Germany, for Europe to seek ways to "decouple" from the dollar.

One way to do so would be for the European countries (perhaps as a group) and Japan to crack down on their capital outflows.[17] For example, they could install an Interest Equalization Tax (IET), as the United States did in 1963 when faced by similar circumstances: a current account surplus more than offset by capital outflow due largely to higher interest rates abroad. The US IET only worked for a couple of years, although it stayed on the books until 1974, but it exempted much of the capital account and a good part of the world so is not a very precise model for similar action today.

A contemporary effort by Europe and Japan would have to be quite comprehensive in scope, except perhaps for bona fide export finance and credits to debtor developing countries, and applied much more vigorously. Given the magnitude of today's capital markets, there would still be considerable leakage. But many billions of dollars of capital outflow could presumably be checked rather quickly, turning the tide in the exchange markets.

17. In principle, the United States could also try to limit capital inflow, as Germany and Switzerland did in the late 1960s and early 1970s. However, the vast size of the US capital market and the widespread international use of the dollar, along with the fact that it is always easier to control your own residents than non-residents, suggests greater effectiveness of actions initiated by the other countries (but, as noted below, fully supported by the United States).

Those who recall the relatively modest (and short-lived) results of the US capital restraints of the 1960s also ignore one vital difference between then and now. If Europe and Japan took such action today, they would be moving toward underlying equilibrium whereas the United States was trying to shore up a currency which turned out to be substantially overvalued. Thus a European-Japanese IET would be moving with, not against, underlying market forces and should have a good chance of working. The key is to achieve a convincing shift in short-run market trends, which could be done by offsetting the interest-rate advantage that temporarily props the dollar without permanently distorting the international capital markets.

Alternatively, the Europeans and Japanese could simply shut down most capital exports for a while through quantitative controls. Japan, in particular, could use administrative guidance to check temporarily the massive foreign investments of its insurance companies, banks and other large institutional investors.[18] The techniques involved should be determined by each country, but implemented jointly and quickly to have the desired psychological as well as real effect on the exchange markets.

18. As they are reportedly already doing to some extent. It should be noted, however, that the thrust of the Reagan-Nakasone agreement of November 1983 was for Japan to open its capital markets further -- which could well promote more capital outflow and thus again weaken the yen. For recommendations on the yen see C. Fred Bergsten, "What to Do About the US-Japan Economic Conflict," Foreign Affairs, Summer 1982.

36-133 O—84——10

Once the tides were turned, and the correction was underway, joint intervention in the exchange markets by the US and foreign authorities could accelerate its pace and extent. In addition to joining the intervention effort once the market trends were turned, the United States would of course have to endorse fully the actions of the capital-exporting countries (to obviate any fears that their actions were taken "against the United States").

To be sure, steps aimed at direct manipulation of capital flows (or exchange rates themselves) are decidedly inferior to dealing with the fundamentals of the situation: primarily the huge ongoing budget deficits in the United States and the resulting high real interest rates which support the dollar at overvalued levels. Action on these basics must, and surely will, eventually occur. But the uncertain outlook for their early resolution and the costs of inaction--as detailed above--are extremely high and growing steadily worse. It is thus critically important that this committee, and the rest of the Congress, succeed in the current effort to move decisively to enact substantial, lasting, and credible reductions in the budget deficits--for external as well as internal reasons.

The CHAIRMAN. Mr. Roach.

STATEMENT OF STEPHEN S. ROACH, VICE PRESIDENT AND SENIOR ECONOMIST, MORGAN STANLEY & CO., INC., NEW YORK, NY

Mr. ROACH. Thank you, Mr. Chairman.

I would like to leave you with three basic conclusions regarding the impact of the trade deficit on the macroeconomic environment.

One, because of a growing trade deficit, this expansion is being built increasingly on a very precarious mix of foreign and domestic production.

Two, the dollar is moving to center stage, insofar as its potential impacts on inflation, interest rates, and ultimately the sustainability of this expansion are concerned.

Three, our trade problems cannot be dealt with on a piecemeal basis. They clearly affect the broader choices that critically bear on the stance of fiscal and monetary policy.

You have just heard about the dimensions of our eroding trade position. I would like to start where that description leaves off and pose the following question: What does the extraordinary degree of import penetration that we have had in this cycle imply for the stability of this expansion?

In answering, let me suggest that there are really two alternative ways of assessing the tone of this economic recovery. One is the conventional yardstick of real GNP. There the verdict is fairly unanimous: We have had a close to normal recovery.

An alternative concept, and one that I think bears more on the deliberations of this committee today, is to look at what we call gross domestic demand. That measure strips out the trade balance from GNP, and in turn represents the sum total of purchases made in the United States by businesses, consumers, and government units, irrespective of which country actually produces the goods or services.

From this second vantage point the obvious and very important conclusion in comparing the present expansion to that of earlier cycles is that heightened penetration of foreign trade has opened up an unprecedented gap between national production, or GNP, and domestic demands.

Thus, while it is certainly true that GNP has risen close to the standards that we have seen in earlier business cycles, this was achieved by what we would call a dangerous and risky combination of sharp foreign trade penetration on the one hand, and almost an explosive expansion of domestic demands, on the other hand.

Indeed, when examined on a quarter-by-quarter basis, the recent expansion of domestic demands in the United States has been striking. With the exception of the first quarter of 1983, they have risen about 25 percent faster than they have at similar stages in earlier business cycles.

Plain and simple, this gives the erosion in our foreign trade position the dubious distinction of being the only thing that stands between our so-called normal recovery and a potentially dangerous burst in production at home that would be required to satisfy today's vigor of domestic demands.

Now, how have we been so fortunate? I think the other participants on this panel have already indicated that the critical factor behind what could be called the encroachment of foreign production on our recovery has been the strength of the dollar in foreign exchange markets.

My comments suggest, however, that the United States is increasingly vulnerable to a significant downside correction in this currency—and by significant I mean a drop in excess of the 10- to 15-percent trade-weighted correction that markets, essentially, are priced for today.

If the dollar falls by more than that amount and domestic demand stays on the track at roughly the same vigorous clip, then growth in domestic production would have to rise very sharply to pick up the slack left by the absence of imported goods. The result, in our judgment, would be a 25-percent acceleration in the rate of growth of GNP, and a recovery that no one would dare call normal. Such an outcome would obviously have ominous implications for inflation: First, it would lead to more intense pressures on labor and product markets. The capacity-utilization rate would be pushed well above current levels and the unemployment rate would be considerably lower than would otherwise be the case; and

Second, it would raise import prices sharply. The obvious point here is that in translating import prices back into dollar terms, it makes a world of difference as to how the dollar is valued against the major currencies of our trading partners. Under a strong dollar, such prices look very attractive. Under a weak dollar, they look terribly expensive.

Thus, a return to a weak currency certainly could turn the tables on domestic prices and potentially unleash a new round of inflationary pressures in our economy.

As has already been indicated this morning, the story does not stop with inflation. With a weaker currency and a declining trade deficit, capital inflows dissipate, and the loss of such funds, that criticaliy augment domestically generated savings, is clearly the other edge of the sword. And the risk here, of course, is that in the absence of such capital inflows the long-heralded clash that we in Wall Street have been worried about for years would be upon us with a vengeance: Real interest rates would rise, credit-sensitive demands would sag, and the economy would once again be threatened by recession.

Summing up, I would argue that a weak dollar, in the context of today's high levels of import penetration and the very vigorous growth we have seen in the domestic demands of this economy, would lead us right back into the worst of all possible outcomes—an unstable economy on the brink of recession, and accelerating inflation.

The imperatives of macro policy options are obvious in this regard. A firm monetary policy is absolutely essential to prevent anything close to a run on the dollar and to protect the foreign capital that we need to help finance our budget deficits.

There is, of course, the alternative that you have been facing in this committee, and that is a reduction in the Federal budget deficit. But clearly much more needs to be done in this regard. If a significant breakthrough occurred, that would, in turn, limit our ap-

petite for foreign capital and also permit, hopefully, a more realistic mix to our macro policy choices. As has been said for years, monetary policy cannot do the job alone. And in the context of the multiplicity of problems trade issues impose on the policy choices, the imperatives of resolving the issue of both deficits—trade and budget—have never been greater.

Thank you.

[Mr. Roach's prepared statement follows:]

FOREIGN TRADE AND ECONOMIC EXPANSION: DANGERS OF THAT OTHER DEFICIT

Statement of

Stephen S. Roach
Vice President and Senior Economist

Morgan Stanley & Co., Incorporated

before the

Committee on Finance

United States Senate

March 23, 1984

Mr. Chairman and members of the Committee, I welcome the opportunity to participate in this timely hearing on the growing trade deficit. For most of our history as an industrialized nation, the United States has prospered without excessive dependence on foreign trade. The tide has turned, as our trade position is now moving through a steady succession of record deficits. Yet, despite this turn of events, there is only limited comprehension as to what this trend implies for a broad range of economic problems.

In this light, there is widespread conviction that we are experiencing a normal economic recovery. The profile of our GNP seems to bear that out: an increase over the first five quarters of this expansion that closely resembles rebounds of the past. Unfortunately, such trends in the GNP mask a growing instability in the economy that can be traced to the sharp deterioration in our foreign trade position. That, in turn, is a problem that ultimately threatens not only the sustainability of this expansion but also the chances for continued tranquility on the inflation front. As a result, our fiscal and monetary authorities face urgent and critical choices.

FOREIGN TRADE PENETRATION

It should come as little surprise that recovery in the United States from the last recession has been accompanied by an erosion in our country's foreign trade position. Typically, the failure of exports and imports to move in close alignment with each other results from a U.S. economy that is a "step ahead" of the cyclical adjustments of its major trading partners. Foreign appetite for U.S. goods generally remains listless in the first year of recovery while import demand moves ahead appreciably. The unusual feature of the present experience is that over the course of 1983 our trade position -- as measured on a GNP basis -- deteriorated more than twice as steeply as it did in comparable periods of earlier recoveries.

As Figure 1 shows, last year's atypical performance cannot be attributed to unusual sluggishness of foreign demand for U.S. goods and services. Indeed, after adjusting for inflation, exports actually rose 3% over the four quarters of last year -- slightly outperforming the typical recovery pattern of the past. The difference then is clearly on the import side. Imports rose almost 22% in real terms between the fourth quarter of 1982 and the final period of 1983 -- a pace over twice as rapid as the 10% rise in the first year of earlier cyclical rebounds.

Moreover, the evidence points rather decisively to a broadly based penetration of foreign-produced goods into U.S. markets. This is underscored in Figure 2, which provides a breakdown of import demand by major commodity grouping. With the exception of petroleum imports -- which have been depressed in part by the glut in world oil markets -- the comparisons relative to earlier recoveries are striking. Imports of capital goods have risen seven times faster in this economic upturn than in recent recoveries; for consumer goods, the increment is twice the size of past cycles; and for industrial materials and supplies (excluding oil), the increase in imports vis a vis previous cycles is staggering. Even in the automobile area, where restrictions with the Japanese have curtailed foreign shipments, import growth has still managed to outdistance that of recent recoveries.

The reasons behind this sharp surge in imports are well known. A recent study by the Federal Reserve staff concluded that a strong dollar in world currency markets is the major culprit; virtually none of the extraordinary deterioration in our trade account could be attributed to any unusual features of the worldwide business cycle.[1] There have obviously been other factors at work as well, especially unusual shifts in the composition of domestic demand that clearly bear on the "mix" of import growth. These

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[1]See Peter Hooper and Ralph Tryon, "The Current Account of the United States, Japan, and Germany: A Cyclical Analysis," International Finance Discussion Paper No. 236; Board of Governors of the Federal Reserve System, January 1984.

include the remarkable vigor of the current capital spending rebound as well as the extraordinarily lean conditions of business inventories in many lines.

HOW NORMAL A RECOVERY?

The implications of heightened import penetration are inescapable. Foreign economies have staked out an unprecedented claim on economic recovery in the United States. The dimensions of that claim show up clearly in Figure 3, in which the recent slippage in our trade account (the shaded portion in the upper panel) contrasts sharply with that which has occurred in earlier periods of economic expansion (the lower panel). And as long as the trade balance continues to erode, foreign production will absorb an increasingly larger portion of the expansion in domestic demand.

One implication of such a development is that real GNP has lost a good deal of its relevance as a gauge of overall economic activity. Indeed, over the last three quarters of 1983, gross domestic demand -- or real GNP less net exports -- rose at a 9.2% average annual rate. That represents the growth pace of total purchases made in the United States by consumers, businesses, and

government units -- irrespective of which country actually provided the goods or services. Over the same period, real GNP or domestic production grew about 25% slower than such demand.

It is the vigor of this surge in domestic demand that discredits the GNP and throws cold water on claims of a normal recovery. For when judged against comparable periods of earlier cycles, the expansion of gross domestic demand over the past three quarters also turns out to have been about 25% faster. Moreover, the "flash" report of first-quarter GNP, released earlier this week, implies such vigor is clearly continuing; gross domestic demand probably rose in real terms by an annual rate of at least 8 1/4%.

Thus, our normal recovery turns out to be a rather peculiar blend of extraordinary vigor in domestic demand coupled with a sharply eroding trade position. Absent the latter, then real GNP would have to have grown considerably faster than it did in order to satisfy the vigor of domestic purchases. There is little chance that if such had transpired the recovery would in any way be described as normal.

MIXED BLESSINGS

On the positive side, the extraordinary penetration of imports has limited the inflationary pressures this recovery could have generated in markets at home. If this expansion's excessive growth in domestic demand (upper panel of Figure 4) had been reflected in comparable increments in national production, the prognosis for inflation would be all the more ominous. Indeed, in a "closed economy" -- one without access to foreign markets -- GNP growth would have had to match the expansion of domestic purchases. As pointed out above, this would have raised the speed of recovery by about 25% over the past year. That, in turn, would have generated a capacity utilization rate that we estimate would have been almost two percentage points higher than the latest reading of 80.7% (lower panel of Figure 4). Moreover, an 85% operating rate -- commonly perceived to be a "flashpoint" for inflation -- would be easily attainable by this summer.

Admittedly, a closed economy is an extreme example. But as Figure 3 emphasizes, such a characteristic is far closer to the cyclical norm than is the present expansion. Thus, the substitution of foreign for domestic production has produced less of an inflationary bias to this expansion than might otherwise have been the case.

The flip side, however, underscores the steep price that public policymakers have had to pay in order to foster an economic recovery built on a precarious mix of foreign and domestic production. When monetary policy was eased in the summer of 1982, the intent was clear -- a reemphasis on economic recovery after a protracted and painful recession. While the precise targets of such recovery were never made explicit, there was an obvious effort to promote an expansion in output vigorous enough to bring the unemployment rate well below the excesses of its double-digit highs.

Declines in joblessness, however, are a function of rebounds in GNP or domestic production. And, as we have seen in the present expansion, an obvious by-product of a sharply eroding trade position is the opening up of a considerable gap between GNP and domestic demands. Thus, in order to reduce unemployment, policymakers are forced to stimulate demand to grow well in excess of production. If they don't, continued job loss associated with steady import penetration can offset a sizable portion of the potential reduction in unemployment. In essence: jobs are exported as the trade balance erodes, and to compensate for this public policy has to "overstimulate" demand at home. The risk of such a strategy is considerable. If foreign trade penetration is less-than-expected, a given path of domestic demand lends more vigor to the rebound in domestic production. In contrast, if the

trade position deteriorates more steeply than expected, attempts to reduce unemployment could be perpetually frustrated. Not the best of odds for even the nimblest of policymakers!

THE DOLLAR HOLDS THE KEY

At the heart of the dramatic shifts that have taken place in our trade position lies the dollar. No matter how you cut it, the dollar has appreciated dramatically against currencies of our major trading partners. Relative to the lows of 1980, by early this year the dollar had risen in excess of 50%; compared with what some might call a more normal benchmark, i.e., the 1973-79 average, the rise has been greater than 30%. In light of such gains in currency valuations, trade adjustments should hardly come as a surprise. Exports are harder to sell when prices are translated into foreign currencies, and imported products look increasingly attractive when their prices are quoted in dollar terms.

What if the dollar falls? Over the longer haul, of course, such a decline is inevitable. The correction ultimately reflects the response of U.S. producers to eroding market shares at home and abroad; competitive pressures reduce the trade deficit, which

brings the dollar into better alignment with other currencies. However, shorter term considerations -- such as shifting investor preferences for dollar-denominated assets -- could speed this process up considerably. And, the recent turn of events in world currency markets points to the first signs of just such a weakening. Indeed, questions have increasingly turned away from whether the dollar will fall to how steep the drop will be.

A decline in the dollar is not something to take lightly in today's precarious environment. While a drop of 10% to 15% from this year's peaks (on a trade-weighted basis) would probably be manageable, anything in excess of that amount would be problematic. At today's high levels of import penetration, we quickly become importers of inflation; the upper panel of Figure 5 illustrates how a weaker dollar can alter the attractiveness of import prices rather dramatically. That, in turn, lessens the competitive pressures to limit price gains of domestically produced goods. While import growth should slow as a result, that implies that for a given level of domestic demand there will be a substitution back into domestic production.

Ultimately, a falling dollar produces a double-whammy on inflation. Dollar-related pressures suck inflation back into this country, and accelerating growth in domestic production adds to existing pressures in markets at home. The lower panel of Figure

5 illustrates how changing dollar values can affect the overall price level by tracing the likely path of inflation over the past several years -- had the dollar not risen. Conventional tools used to estimate such impacts suggest that if the prospective drop in the dollar could be contained to the 10% to 15% zone, the inflation rate would rise by about one percentage point within a year. A "run" on the dollar in excess of that amount would accelerate inflationary pressures considerably more.

Unfortunately, the story doesn't stop with inflation. The mirror image of shifts in trade positions is volatility in foreign capital accounts. A deficit on current account is financed by inflows of assets from abroad. And such inflows, which augment the value of domestically generated saving, are coming at a most auspicious point in time -- when they are critically needed to serve as a buffer between private credit demand and the public sector borrowing associated with our massive Federal budget deficits. With the President's Council of Economic Advisors estimating that such inflows will offset about 40% of the Federal Government's financing needs this year, foreign capital clearly holds the trump card in any prospective "clash" in our financial markets.

From that point of view, a run on the dollar would be an unmitigated disaster. With the trade balance improving as a result, inflows of foreign funds would slow and the intensified competition between public and private sector demand would bid up real interest rates -- the price of financial capital. Credit-sensitive demand of businesses and consumers would probably be "crowded out" at the margin and, depending on the friction that ensues in financial markets, that could tip the economy back into recession.

The result is an all too familiar nightmare: an unstable economy moving back to the brink of both recession and accelerating inflation -- all because the dollar falls too sharply against a backdrop of large budget deficits and a growing disequilibrium nourished by extraordinary import penetration. The Federal Reserve, as a consequence, is left with little choice. The dollar must be defended by a firm monetary policy -- one that ultimately protects the foreign capital that has become the sustenance of this expansion.

There is another way out: a meaningful reduction in the budget deficit. For the two deficits are intimately related to each other. Reduce the budget deficit and the need for foreign capital becomes less essential. The dollar would then be allowed to follow its natural corrective tendencies and U.S. industry would

36-133 O—84——11

be provided with an improved competitive environment. All that and more from a long overdue shift in our policy mix. Given the precarious state of the current expansion, there is simply too much reliance on monetary policy to attack the multiplicity of problems we face.

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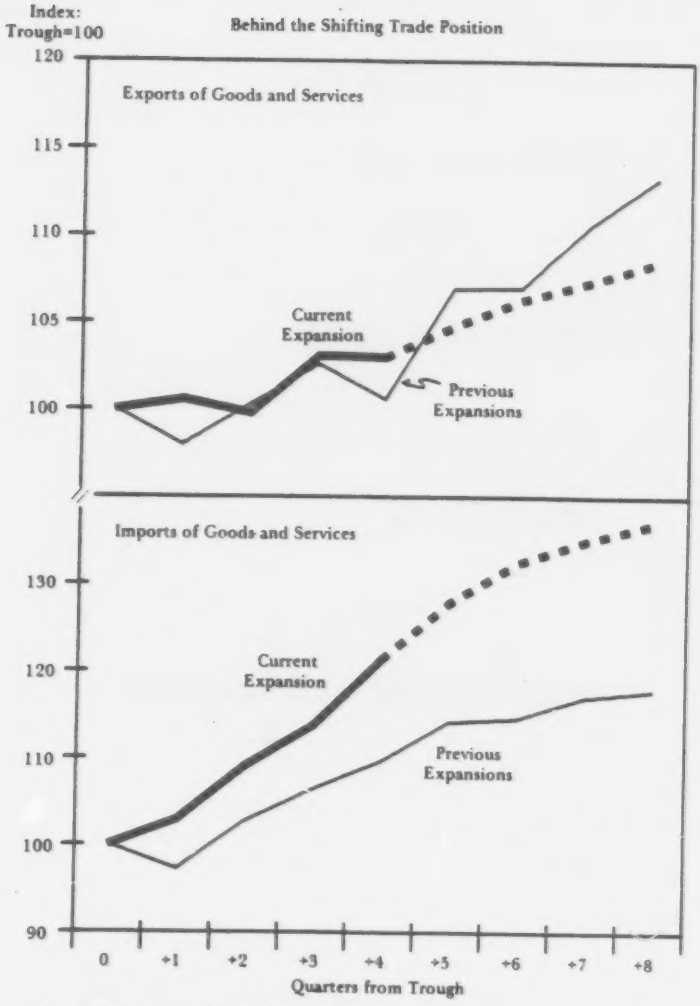
Figure 1

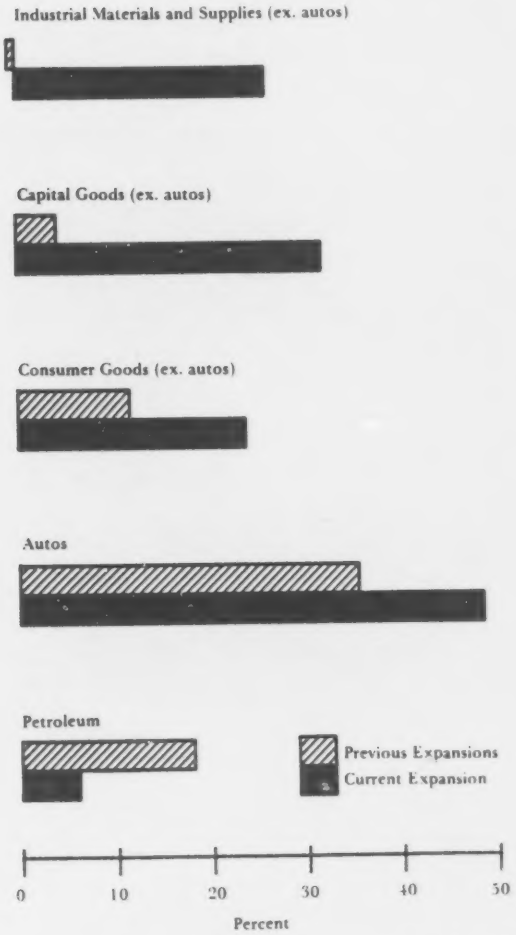
Behind the Shifting Trade Position



Note: Previous expansions include the five most recent business cycles excluding the 1980 credit-controls-induced shock. Dashed lines indicate Morgan Stanley Economics projections. All trade data are from National Income and Product Accounts.

Figure 2

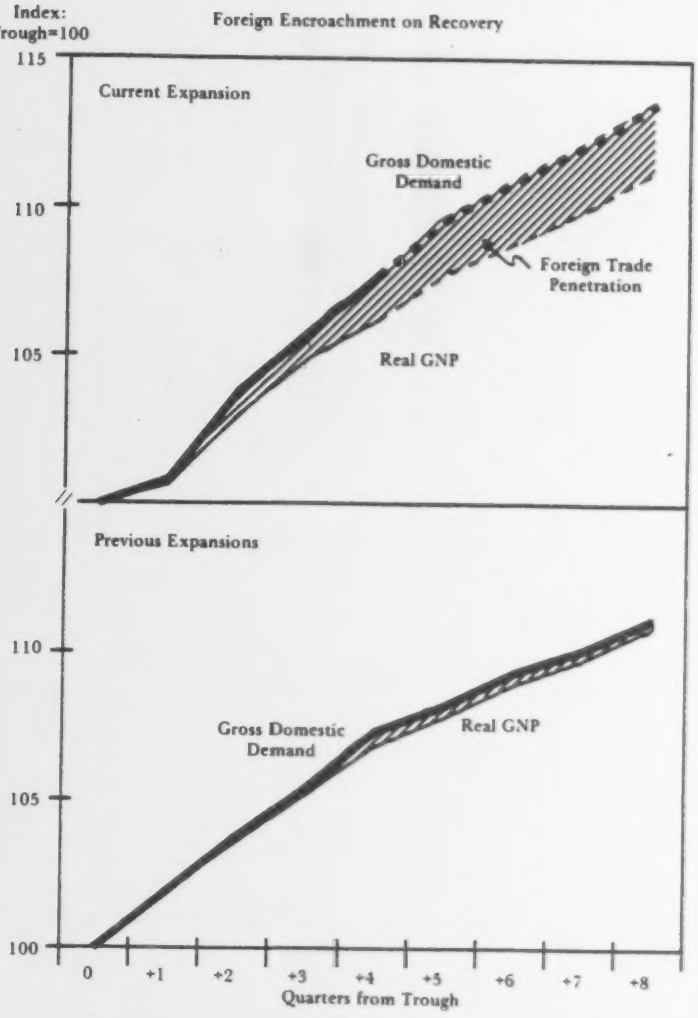
Surging Import Demands
Percent Change in First Year of Expansion



Note: Previous expansions include the recoveries from the recessions of 1969-1970 and 1973-1975.

Figure 3

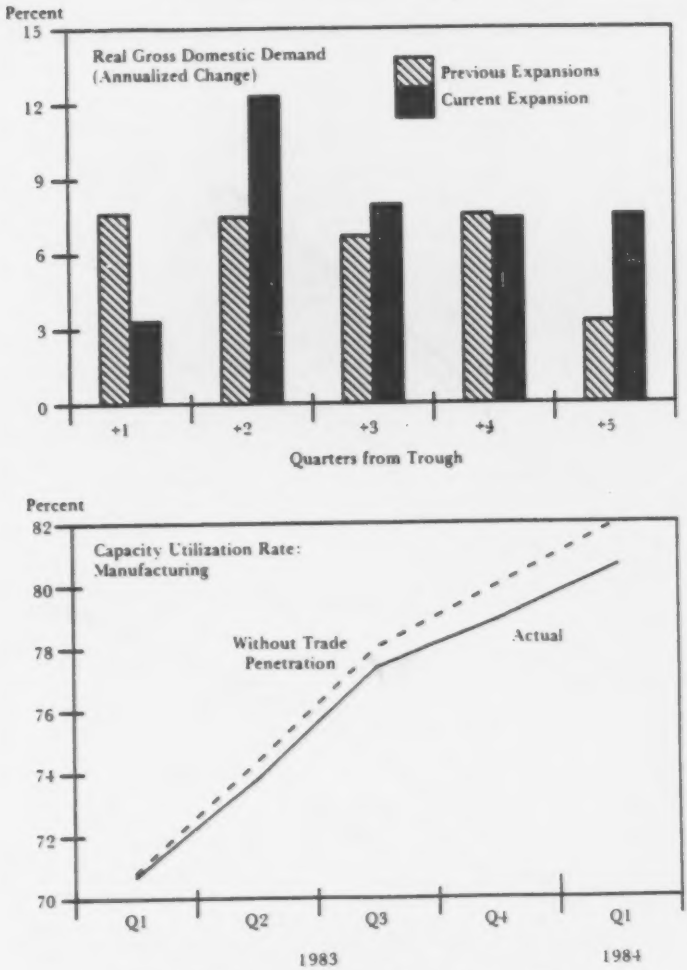
Foreign Encroachment on Recovery



Note: Gross domestic demand equals real GNP less net exports. Dashed lines indicate Morgan Stanley Economics projections.

Figure 4

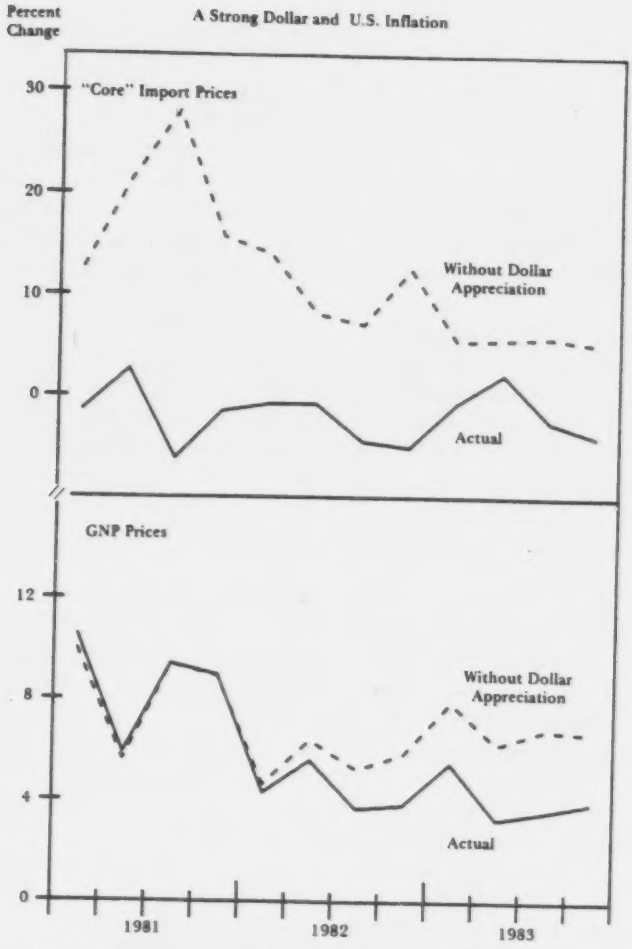
Domestic Demands and Capacity Pressures



Note: Adjusted series on capacity utilization (Federal Reserve basis) was estimated under the assumption that manufacturing output would have absorbed the increment between domestic demand and domestic production.

Figure 5

A Strong Dollar and U.S. Inflation



Note: Core import prices were obtained by constructing an implicit deflator for merchandise imports, excluding petroleum, food, and automobiles. The adjustment for dollar appreciation holds the trade-weighted value of the dollar at its 1980-Q3 low; the plotting of this adjusted series is a four-quarter moving average. The adjustment to the GNP implicit price deflator is described in "Reconciling Monetarist with Structuralist Views of Inflation in 1984," Morgan Stanley Economic Perspectives, October 27, 1983.

The CHAIRMAN. Thank you very much.

I am going to ask a couple of questions, if Senator Long doesn't mind.

Senator LONG. Go right ahead.

The CHAIRMAN. Then I will leave him here, because I do have a 12:30 problem.

I wanted to ask Governor Wallich: You have mentioned that the United States is rapidly liquidating its position as a creditor nation. I guess, first of all, where is this trend going to take us? And do we ultimately end up in the hands of the International Monetary Fund, which responds by imposing austerity measures on our economy? Maybe that is the only way we can address it, if the Congress doesn't have the will, or the administration—any administration.

Do you have any comments or thoughts on that?

Governor WALLICH. Mr. Chairman, I think the process is less visible and a more subtle one than something that would cause the United States to go to the IMF. Our international net investment position, even now, if we make certain statistical adjustments, shows virtual balance between the international claims and international liabilities. At best, we've got a net creditor position of somewhat more than $100 billion if we don't make these statistical adjustments.

Now, the deterioration of that position does not lead us to a situation in which we can't pay our debts, for several reasons: First, the balance is not very great. More fundamentally, these debts are denominated in dollars, and so we are not going to run up against a foreign exchange shortage.

But the more subtle damage is that which also Mr. Bergsten pointed to: We lose a part of our GNP by having to pay interest abroad. It's not like interest owed domestically; it's interest paid abroad, which is a drain on the Nation's resources. And, of course, if that situation makes people less willing to hold dollar securities, it means downward pressure on the dollar, which relieves certain problems and brings into sharper focus some others.

The CHAIRMAN. I guess Mr. Bergsten tried to address this. I guess what we are searching for is, What can this committee do about the trade deficit? We have been told that while we are addressing the general deficit, we are told not to get involved with section 122. Do you recommend anything else we might do at this level, or would you have to wait and see what happens to the dollar, if there is a sudden drop, and then what would the Fed do?

I guess we are searching for answers. Tim, do you have any suggestions?

Secretary MCNAMAR. Well, I think that, in fact, caution is what I would advise, and not to react to what may be short-term phenomena as opposed to secular trends. I think this committee has always taken the longer view, and I think that is wise at this point.

There are great questions, as I pointed out in my longer testimony, about the adequacy of the data and the empirical base that it's derived from. We have about a $100 billion statistical discrepancy, when you go around and add up the current accounts around the world, and you would expect the surpluses and the deficits to all

add up. And the U.S. data are out of sync by $40 billion per year in 1981 and 1982.

So I would tend to take a little longer view, and I would, again, caution—as attractive as it may be to retaliate against Japan or any other individual country—I would avoid bilateral actions. Most of all, I would avoid any type of an action that shoots ourself in the foot. It doesn't do a lot of good to protect one segment or one industry group, if in doing so you are going to disadvantage an even larger number of Americans. And I think that Congress has to be cognizant that it is in effect picking one group to be advantaged, to the disadvantage of another group, when it enacts the kind of surcharges or quotas that might be imposed under section 122.

The CHAIRMAN. Fred, you had talked about an interest equalization tax. Is that something we might look at?

Mr. BERGSTEN. Yes.

Two points: I wanted to say, in response to what Tim just said, I am all for taking the long view, too; but in my long view, the situation is going to continue to deteriorate and get worse, and I would like to ask him if he has any hope for us that we could look to for a turnaround?

Second, there are only three ways to go about dealing with the policy response. One is at the macroeconomic level. You've done what you can on the budget deficit; obviously you are going to make every effort. That is the most important thing.

But, short of that, you can only interfere directly with either trade flows or capital flows. As I pointed out, if you interfere with trade flows it will tend to push the exchange rates in the wrong direction, and you will get an offset.

So, not out of any love for manipulating capital flows, to be sure, I come to that as a third best, but maybe the only thing you can look at.

Now remember, when I say "interest equalization taxes" it is by the other countries, by the Japanese, by the Europeans, because they are the ones now with the interest rates much lower than ours. They would have to put the tax on to offset that differential, like the United States did when the shoe was on the other foot—20 years ago.

Now, there are all sorts of techniques. In the case of Japan, I already suggested 2 years ago what I called the 30 phone calls approach: The well-known administrative guidance system in Japan, demonstrably in recent time, has enabled the Ministry of Finance to pick up the phone, call up the insurance companies, pension funds, and banks, to suggest rather strongly that they limit the capital outflow for awhile. And they've done it. They did it after the second oil shock. They could clearly cut the capital outflow from Japan, which is very large, by very substantial amounts, at least for a few quarters or a year or so, and that would strengthen the yen and help bring the correction from that side.

Again, this is messy, it is not the kind of thing that an economist normally espouses or even writes about; but given the very poor outlook, the risk of inaction on the more desirable fronts, I'm afraid those kinds of things have to be contemplated.

The CHAIRMAN. Mr. Roach, do you have any quick fixes we might take up in this committee?

Mr. ROACH. My main message to you has been on the macro-policy mix. And while the committee is obviously to be commended for the recent progress that has been made on the budget deficit, I can assure you that perception is widespread in the financial community that not nearly enough has been done. Until we make meaningful progress on reducing the growing structural deficit as they stretch out over time, our economy remains increasingly vulnerable to the ups and downs in currency markets. To finance our outsized budget deficits, we desperately need foreign capital inflows. Absent such funds, today's interest rates will look pale in comparison to what we see down the road.

The CHAIRMAN. Tim, you know you are preaching caution and it sounds like Walter Mondale, "dare to be cautious." [Laughter.]

How much longer can we do that?

Secretary MCNAMAR. That's probably because I identify with his generation. [Laughter.]

I think that we can do that for a couple more years, with some certainty and some comfort. I would say that, because with Mexico making the financial progress that it looks like it is, I think you might expect a turnaround in our trade balance there in the neighborhood of $10-plus billion. I think with the other non-OPEC LDC's, you might be looking at another $5 to $10 billion. I think that if the price of oil stays about where it is, I think you could see some improvement in the OPEC trade balance there, probably in the neighborhood, again, of $5 to $10 billion.

Then, as Western Europe comes back, and the other industrialized countries, I think you could be looking for a minimum of $5 to $10 billion there.

Well, you start to add that up, and if you assume that there is approximately a 2-year lag between any impact that the exchange rate has on the trade balance, we are still, this year and next year, going to be experiencing the high dollar of 1983.

Well, if the dollar—as many people have suggested this morning—is going to level out or depreciate somewhat during 1984, you are really not going to begin to see the benefit of that in the trade flows until probably 1985 and 1986, and at that point you are not going to know whether it was the dollar or the recovery in Western Europe that caused it, I would suggest.

The CHAIRMAN. Thank you very much.

I am going to leave you to the tender mercies of Senator Long. I'll be back about 2 o'clock, if you are still here. [Laughter.]

Senator LONG. I hope to be through before 2 o'clock, Mr. Chairman. Thank you very much.

I have difficulty buying the theory that we are not going to look at individual industries, we are not going to look at individual countries, and that instead we are going to just face this problem as an overall macroeconomic matter, without focusing on the individual problems.

For example, is there anybody here who honestly, in his soul, feels that the voluntary agreement with Japan on automobiles is really voluntary? That the Japanese just, absolutely, out of the love in their hearts for the American automobile worker put those quotas in effect? Does anybody really think that?

[No response.]

Senator LONG. Well, if you really do, say so, because to me it is pretty obvious what happened—we tell jokes in back rooms about how we thought that was arranged. You can speculate however you want to, but it is obvious to me that what happened was this Government made clear to the Japanese Government that we were not going to sacrifice up our automobile industry to the concept of free trade.

Secretary MCNAMAR. Well, let me raise a question about that, Senator. I think the Japanese put on those self disciplines or restraints, VRA, whatever you want to call it, as a second-best choice, for fear that the United States might pass a local-content bill, or some worse action. So, in that sense, the burden of making the choice among unacceptable alternatives was shifted. If you want to call that a "voluntary agreement," I would agree. If you want to say that that was a "presentation of heinous choices" that one had to pick from, I would probably agree with that, too.

Senator LONG. Well, I don't know how the scenario would have been worked out; I don't know how we would have gone through all that charade; but there is no doubt in my mind that if they hadn't put those quotas into effect, either the administration would have recommended that we impose a quota, or else they would have——

Secretary MCNAMAR. But think of the results that we have today.

Senator LONG [continuing]. Indicated that they didn't think Congress had much choice about it, and that they, the administration, might be compelled to go along with it. But in any event, the administration wouldn't have been up here fighting it as though their life depended on it. It would have happened, although the Japanese did it because——

Secretary MCNAMAR. Self-interest.

Senator LONG [continuing]. They were convinced that the alternative would be that if they didn't do that, they would get something less satisfactory to them.

Secretary MCNAMAR. Exactly.

Senator LONG. It is about that simple, isn't it?

Secretary MCNAMAR. But look what the result of that action has been. I don't have the numbers in front of me, and I would be delighted to submit them for the record, but I think there have been some studies that suggest that car prices in the United States are at least $1,000, and as much as $2,000, a unit higher now than they would have been if an unlimited number of Japanese cars had continued to come in. Some of that increase has been due to a shift to higher quality, more expensive Japanese cars; only about $1,000 per car is due specifically to the rationing effect of the VRA.

I have also read reports out of Detroit that a couple of the automobile companies are suggesting that they are reaching their capacity limits. They can't produce some cars as fast as the American people want them now, because the recovery has come, consumer confidence has come back, interest rates have been relatively stable, people are not worried about losing their jobs, and they are starting to replace that stock of cars that we have out there, that at the beginning of 1983 was about 7.4 years old on average, and therefore getting maybe 8, 10, 12 miles a gallon. They are starting

to replace them with these new cars getting 24, 25, 26 miles per gallon, whatever it may be.

The process is working. And now I think there is a question as to whether we haven't disadvantaged 230 million Americans for the benefit of 750,000 automobile workers. I don't know. I would raise that question.

Senator LONG. Well, it's all right with me to use this free trade policy as a leverage point to make those workers settle for lesser wages and to make the management do whatever is within their power to improve their efficiency, and all the rest of it. I am not quarreling with that.

But it is clear to me, also, that this industry would have been liquidated but for the decision of this Government that that wasn't going to happen.

Now, however that was done, whether it was done subtly or whether it was done openly, or what was said in the back room, that is sort of immaterial to me. That was clearly the decision of this Government, and one way or the other we participated in it. We didn't think that industry ought to be liquidated, and we weren't going to let that happen, although we preferred the scenario we have to the scenario that would have happened otherwise.

Wouldn't the same thing be true, to some extent, for the steel industry? I am not talking necessarily about this administration, I mean just the trend that has been going on in recent years. One way or the other, we more or less decided that we just didn't feel like we ought to liquidate that steel industry.

Secretary MCNAMAR. Senator, I don't think the automobile industry would have been liquidated, and I don't think the U.S. steel industry—absent any Government action—would be liquidated.

I think basically you come to a choice, and I think you are suggesting that you would prefer that politicians in Washington make decisions to slow the rate of structural adjustment in an industry, as opposed to allowing that to be set by market forces. And that's the basic choice.

Senator LONG. I am not saying that. What I am saying is that this Government does look at individual problems, individual trade problems. It has been my experience up here that when some poor soul comes from out in the hinterland and has himself a real problem, and it involves trade, if we don't want to do anything about him we send him over there to Geneva and tell him to go talk to the GATT. And after he spends about 2 or 3 years over there he comes back to report that there is no help available. Then, if we want to do something for him, whether we do what was done with regard to the automobile industry or what we've done with regard to somebody else, we act. And usually it is a unilateral action, if we decide we want to do something about it. I've seen those things done with regard to more industries than one, and I'm looking at it just from the foreign perspective.

It just gets down to a matter of priority—how important is it? For a major industry, we will think a long time before we will see it go out of business. If it is not a big industry, well, that's unfortunate, but at that point the theory of free trade will be applied to him.

Now, in dealing with our trade problem, I for the life of me don't see any problem with us working something out with Israel; nor do I see any problem with us working out an agreement with Canada. We have a good relationship, and it's a pretty reciprocal bilateral arrangement with those countries. If we are moving toward a free-trade arrangement with Canada, so much the better.

But I for the life of me don't see how we can do the same thing with regard to Japan, where we have got a real problem.

Now, we have a real problem with Mexico. And, if I do say it, that comes as a part of our own comedy of errors. Back at the time when energy was in very short supply here, Secretary Schlesinger and his people insisted on breaking up those contracts with Mexico. We could have bought that gas for less than we are going to pay Algeria for gas, about the same price we pay the Canadians, I assume, and it would have been a good deal for both countries. But, no, we had some bureaucrats who told Secretary Schlesinger that Mexico had no choice—they had to sell to us at whatever price we felt like paying them.

Well, they were outraged, and they said that they weren't going to do business that way. So, what did they do? They said, "We'll just make it into products, and we will sell the products to the world markets and especially to the U.S. market."

So, they are putting the products of natural gas into our market, and they are pricing the gas at whatever price it takes in order to capture our market. And that means that if we don't do something to turn that around, we are going to lose about 64,000 jobs in the petrochemical industry, or that is mainly the chemical industry that we are talking about here. Obviously, that's in the mill; you can see that coming, can't you?

Secretary MCNAMAR. I agree with that characterization. I don't know about the number of jobs, but I think your characterization of what happened and their response is pretty accurate.

Senator LONG. And a lot of that money is American money to build the plants down there, too. As you say, well, now, why didn't somebody think about all this?

I am perfectly willing to look at Mexico's problem and help them. But, again, they are close enough to us to where it is very important to us that that government survives down there; we don't want the Communists to take it over; it is important that it succeeds. But we don't necessarily have to put our industries out of business, especially those that are efficient.

Now, in chemicals, we are efficient, I would think. Don't you agree that we are efficient there?

Secretary MCNAMAR. I don't know exactly, but my understanding is by and large: Yes, we compete rather well in the world. But I think there is a worldwide overcapacity.

Senator LONG. But up until they started pricing natural gas at a very low price, we were an exporter. The raw material is 70 percent of the price of many of these chemical products. We could effectively take on the whole wide world. If they are going to price the raw material, for whatever it takes in order to get the market, then we've had it. We can't compete.

So we are confronted with that, and it gets down to be a question of, "Well, are we going to sacrifice up that industry? Is it sufficient-

ly significant that it ought to survive here? Or are we just going to see it go down the drain?"

My impression from 36 years up here is that, what tends to happen is, the administration will tend to look at that industry and say, "Well, do you reckon it is important enough to us that it's worth saving?" There is an efficient industry, and there is no way it can compete, no matter how efficient it is.

Would you agree with me that in that area, the raw material being the principal cost, and the foreign government can price it at zero cost, if need be, there is no way you can compete with that effectively?

Secretary McNAMAR. I think that's exactly right. I think that, if you look at it not just for the Mexicans but from the Kuwaiti or Saudi viewpoint, obviously they have an interest in having an integrated system, where they produce the raw material at x dollars a barrel and achieve the highest value-added by producing the highest-valued product, which is petrochemicals. And I think that explains some of Kuwaiti interest, for example, in securing petrochemical and refining capacity in Europe.

Senator LONG. Have you read some of the books explaining how they propose to do this?

Secretary McNAMAR. No.

Senator LONG. Any of them?

Secretary McNAMAR. No.

Senator LONG. Mr. Bergsten, have you read any of the books explaining how they propose to move out into the refining and chemical business?

Mr. BERGSTEN. I have read a bit about it; yes.

Senator LONG. Mr. Wallich, have you read some of that?

Governor WALLICH. No; I have not.

Senator LONG. Mr. Roach.

Mr. ROACH. I'm afraid not; no.

Senator LONG. Well, I was just privileged to read one book on this subject. It explained very clearly how they are going to do it, and it's a fail-proof plan. Basically, it is all based on the idea that they will set whatever price they can sell it for. And they can afford to do it, because they can put the raw material at any price they want to put it in for.

There is no way you can compete with that, unless this Government takes the same interest in our industry that they are taking in their industry, saying, "I'm sorry, we aren't going to do business that way." Otherwise, you're gone; I don't see how you can compete with it.

So I just look at a problem out there, as far as a lot of industries and as far as the labor in those industries are concerned, that is a very real problem. And to me it is a question of how much priority we want to give it.

In other words, here we have been conducting fiscal and monetary policies that create real problems. So who is going to bear the pain of it? The taxpayer? Well, no, "we are going to index the Tax Code." No tax increase, because of inflation. The aged people? No, they get their COLA's for the adjustment in their cost of living. The Government employees? No, they get their pay raises, and they get their COLA's on their retirement programs. The military?

No, they get a buildup over and above inflation. Housing? Yes, they will take some of the burden. Some industries will, as will labor in those industries. The consumers take some of the burden. It is a matter of just saying, "Now, where are we going to put the pain?" And it is a matter of saying that among Americans, where do we come down? How important are they too us?

That's how it looks to me. And I don't know how you are going to solve the problem without looking at the parts of it. I just think you have to look at where the problem is coming from.

Secretary McNAMAR. Let me say, Mr. Chairman, I think you really do put your finger on a long-term problem that we are concerned about in the administration. I know this committee and the House committee are. And that is: The inevitable structural adjustment that will have to take place in the OECD countries when they lose out to other countries who have factors of production that are so much more efficient—whether it is because the oil cost $1 a barrel or because the labor is cheap, or because the iron ore is there, or whatever, the hydroelectricity. How will that adjustment be managed throughout the European and North American and Japanese industries?

We have seen that, for example, in Japan, where Japan built quite an aluminum industry, and most of it came onstream just before October of 1973, when you had an awful lot of relatively cheap electricity, which of course is one of the principal ingredients. The Japanese suddenly discovered that their electricity was not so cheap anymore once the price of oil started going up—and you know they import 100 percent of their oil, or virtually 100 percent of their oil. So they have had to scale down their aluminum industry over time.

I think that how the industrialized democracies deal with that is indeed the great trade challenge of the latter part of the 1980's and the 1990's.

Senator LONG. Yes, Mr. Bergsten.

Mr. BERGSTEN. Senator, your comments raise a number of thoughts. Let me quickly mention three:

The first is to say that of course you are right; the United States, like every other country, will deal with industry specific problems as they arise—better or worse than others; sometimes we do it better, sometimes worse. We will deal with them.

I think, however, one should not be misled into thinking that we can make a major impact on these trade deficits of $100 to $150 billion by moving in an industry-specific way. It is true that you might be able to cut imports by several hundred million or a billion, even, in a big industry; even there you might have some exchange-rate offsets and other things that would reduce the net gain—the same point I made on the import surcharge idea.

So, while it is important to work on those, and I have no quarrel with that, and it will be done, one has to look at those objectively, case by case. But I think they would not go very far in dealing with the totality of this massive trade deficit and attendant problems that we have now in the aggregate sense.

The second point: Even with problem industries of the type you have been emphasizing, some of these macroeconomic things are still very important. There have been a lot of studies of the auto

industry, and they all conclude that somewhere between a third and a half of the total problem of the auto industry has to do with the exchange rate imbalance, particularly vis-a-vis the Japanese yen. You referred to that in your comments earlier this morning.

So, even where we know there are particular problems attendant to the industry, the macroeconomic things we are talking about are still critically important to get that industry back to health.

Third, in petrochemicals, we do have laws in this country, trade laws, that say we should hit foreign subsidies: countervailing duty laws, antidumping laws. I think those laws should be applied vigorously. Where there is a subsidy, you should hit it.

Now, on the specific case you are mentioning, the petrochemical industry, there is of course an irony, because as you well know, until very recently the United States was accused of exactly the practices that you are rightly deploring today. Given the fact that we controlled energy prices for so long in this country, I think it was only 3 or 4 years ago that the Europeans were filing countervailing duty suits against U.S. petrochemical exports to Europe, on the grounds that we subsidized the input price.

Fortunately, we have now phased that out, and we ought to be pushing on other countries, as you suggest, to avoid the same kind of practice.

But I think it does undermine our own position a little bit. It makes it a little harder in that particular industry.

Nevertheless, when there is a subsidy, our laws provide a clear remedy: you hit the subsidy, dollar for dollar, percentage point for percentage point. I think we have laws and procedures in place that permit us to handle that problem in the appropriate way. The issue is whether those laws are implemented effectively.

Senator LONG. You said that the surcharge wouldn't work under flexible exchange rates. But if you really wanted to do something about that particular problem, and you just added quotas to the surcharge, you could sure control the imports, couldn't you?

Mr. BERGSTEN. Well, again you would get the same effect. The same thing would occur, because whatever steps you took to reduce imports, you would, by definition, be improving the trade balance. And normally one would expect an improvement in the trade balance, or a perception of a coming improvement in the trade balance, to strengthen the currency.

So, even if it was through a quota, you would tend to get an offsetting move in the exchange rate that would over time—or maybe very quickly, given market expectations—net the whole thing out in terms of the aggregate. There would be differential effects by industry, including the industry that got the quota. If particular industries were protected by an import surcharge, or a tariff, they would probably get some gain—not as much net gain as gross, but they would get some gain.

But elsewhere in the trade accounts, particularly on the export side, you would suffer some compensating losses, so that it would tend, in the aggregates, to net out.

That's the conundrum, in a sense. If you try to think about dealing with the trade deficit through import controls, unless one got a very perverse exchange rate reaction, you would tend to set in

train the offsets to your own gain, and the net effect would be very modest or even possibly a negative.

Senator LONG. Well, let me just state an analysis and see if we can agree on this:

It seems to me that in this world each nation is going to have to assume the responsibility of trying to see to it that their people are employed and that their people are prosperous, and that they have social policies that provide for the care of those who need it and require it.

We will trade with one another, to the extent that we can find it mutually advantageous to trade. But where one nation is planning to get rich at the expense of its neighbors or at the expense of its trading partners, that should require mutual consent. For one country to make its people rich at the other nation's expense, there should be acquiescence of the other trading partner.

Now, for someone to go make his plans that he is going to engage in a course of conduct which is bottomed on unfair trade practice, and then to parlay that into a situation where he is going to get rich at the expense of the other fellow, or even for a third party to expect to get rich as a result of that type of conduct, all should be conditioned on the fact that the person at whose expense they are going to get rich has a right to defend themselves. And otherwise, I don't think it makes any sense at all.

Can anyone really differ with that analysis, Mr. Wallich?

Governor WALLICH. I certainly share the view that these things have to be handled internationally, and unilateral action by one country against another is very dangerous and disruptive and likely to lead to retaliation.

But I see the world divided not only into nations but also into consumers and producers. And what we are talking about here, Senator Long, if I am not mistaken, we are talking mostly about producers, and they have their interests. If their markets are disrupted, they suffer. But consumers far outnumber producers, and they may benefit from cheaper output from a foreign country.

So I think the nation's advantage is not that clearly defined, because one has to weigh the advantage of the producer and the disadvantage of the consumer, both being members of the same nation.

Senator LONG. I thought we pretty well agreed that we aren't expecting any advantage as the result of unfair trade practices by other nations. We are not seeking or expecting any advantage for our consumers as a result of some other nation engaging in unfair trade practices. We are not asking for that or expecting it. If it benefits our consumers, then that's an advantage we are not interested in seeking.

Mr. BERGSTEN. Senator, I think you are making the absolutely critical distinction. Where it is an unfair trade practice, like a subsidization of petroleum feedstocks going into petrochemicals, then I think you are exactly right; you hit it. And we've got laws and procedures in place to do that.

The operational problem comes, as you well know, in defining an unfair trade practice. One man's unfair trade practice may be another man's competitive ingenuity. So you have to have some

standards and some rules, and some ways to monitor that. Honest men can differ.

But when you can clearly define and quantify, hopefully, an unfair trade practice, then you hit it. And the rules provide for countries even to do that unilaterally.

Senator LONG. Mr. Bergsten, you say the rules provide for it. Let me just make one point to clear that, that I think we will all agree to:

When someone is getting ready to engage in such a course of conduct, he looks at your laws, if he's smart. He looks at the rules you have. And he is planning to take advantage of that situation. And when he does that, you had better look at that rule, because that rule might need some modification or some change to look after your interests.

I don't need to go back any further in time than just to the last meetings of the Finance Committee session, where I discovered that our beloved little Commonwealth of Puerto Rico has found a way where they could take advantage of a tax advantage we gave them on liquor, and unless we did something about it they could require the entire distilling industry of the United States to move down to Puerto Rico and make a $4 billion a year profit out of that.

Now, oddly enough, nobody in the Treasury alerted me to all that; they were the ones that were going along with it. It didn't say that that could not be done. It didn't come to my attention until some poor soul in Louisiana showed that he was being put out of business by this.

Well, this could cost the Treasury $4 billion. They became concerned when I became concerned about it, not before.

What Puerto Rico was doing was the subject of advice by the Treasury, which was that this was legal, that they could do it and get away with it. Well, it was never intended to be that way, so it was our burden to change it.

It seems to me that when we find ourselves in that situation, if it is contrary to our intent and the law doesn't provide for it where we have the right to, we ought to.

Do you want to say something about that, Mr. McNamar?

Secretary MCNAMAR. Yes, sir; I don't know that specific example, but I agree with your point, that they do look at our laws and they know what our laws say. And while the administration has not come to this view yet, it would be my personal opinion that it is worthwhile to periodically go back and try to assess whether the existing laws on the book, in fact, are even working properly, procedurally.

For example, we have got a question—or I have a question in my mind—as to whether the countervailing duty laws, which were largely written to apply to individual private firms, companies, in European countries, are appropriate for some of the nationalized or State enterprises that we see springing up in countries such as Korea or Brazil. I think that ought to be examined. I think the committee could do a great service by examining that.

Second, I think you can look at existing procedures, to see whether they are adequate. I am not satisfied that they are, for example, in countervailing duty.

For example, let's assume that you and I could agree on what the subsidy was on a particular steel product that I was selling in the United States. And let's assume it is a 25-percent subsidy on bars. So, after a couple of years of procedural hassle, you put on a countervailing duty. Well, what do I do? I stop sending you so much bar; I shift to rod, I shift to sheet, I shift to billets, whatever. And then I've got another 2 years to exhaust the process until you say, "No, you can't do that on rod anymore," so then I will come back with billets or ingots, or whatever.

I think there is a pattern in practice that develops, that it is worth reviewing whether the existing laws—assuming the countervailing duty law theory is appropriate, and that may be the best we can come up with—I query whether there aren't ways to modify it, to enforce it better.

I think the committee would do a great service to look into that, and the Treasury would be glad to work with you on that.

Senator LONG. Mr. Roach.

Mr. ROACH. Senator, I certainly share your view in condemning unfair trade practices as they occur on an industry-by-industry basis. I would ask, however, is that example you cited, the exception rather than the rule? I think it is more the former than the latter.

I would like to also pick up on the broader macroconsiderations of U.S. industry competing with our counterparts abroad. Taking up where Governor Wallich left off, if our currency remains strong, in large part through policy restraint, then it is my judgment that that would encourage the efforts of American industry to attain superior price performance and superior cost control over time. And the competitive pressures that result from that outcome—however difficult they may be over the short term—would then force the dollar to earn its true valuation in a highly competitive world marketplace.

And I think, in terms of guiding macropolicy over the longer haul, that is something that has to be kept in the minds of our policymakers.

Senator LONG. Do you want to say something, Mr. Wallich?

Governor WALLICH. No; thank you, Senator Long.

Senator LONG. Well, let me ask one further question: Do foreign nations have the ability and potential to manipulate the value of their currency exchange?

You ought to know that, Mr. Bergsten.

Mr. BERGSTEN. Yes; that is something that has been looked at a lot, Mr. Chairman—Senator Long. I am remembering my previous incarnation.

Senator LONG. "Once-chairman," or "ex-chairman." [Laughter.]

Mr. BERGSTEN. Both our former incarnations.

There certainly have been instances where countries have done it. I had a personal experience in 1976, where on a visit to Japan, and in talks to a lot of top people in Japan, I discovered that the Japanese were very sharply manipulating the yen. They were intervening in the exchange markets to keep the yen weaker—significantly weaker—than would have been called for by the market forces that supposedly operate under flexible exchange rates.

I berated them rather sharply about that at the time. They argued that their economy was about to pick up; they would shortly be sucking in imports again, rapidly; so it would be a mistake to let their currency rise, just to fall again.

I rejected that view, and some others did. But frankly, nothing happened during the course of 1976. But when the administrations changed in 1977, I had the good fortune to travel with then-Vice President Mondale to the major European countries and Japan in the first week of the new administration, in an effort to develop new ties, modes of cooperations on economic issues, and we took the advantage of that trip to say behind closed doors to the Japanese, "Get your hands off the exchange rate." We put it very bluntly, very forcefully, very clearly. And they did.

And from that point, the yen began to rise, and with these lags that people rightly talk about—there was still a lot of broken crockery over the next year or so—the corrective process was put in place.

I think that's probably the worst example that I know of of currency manipulation in the postwar period. Other countries have tried to do it, and on occasion have successfully done it.

I would hasten to add that in this most recent period of dollar strength, the last 3 years, I do not see any manipulation of that type. There were allegations a year or so ago that Japan was manipulating the yen at this point. Having found it once, I've looked hard for it again, and I cannot find it this time. Indeed, to the contrary, Japan spent something like $8 billion over the last year or so intervening to keep the yen from weakening further. They in fact are afraid of a weaker yen, because of the further trade competitiveness it would give them and protectionist reaction in this country and elsewhere.

So, on this occasion, I think not. But it has been done in the past; the potential is there; one has to watch it like a hawk.

Senator LONG. I want to raise one other question about that matter: When the dollar is overvalued as it is today—for causes that certainly neither the U.S. industry nor the U.S. workers have control over; it could be the safe-haven aspect of it over which they have no control, it could be our national deficit over which they have no control, it could be the movement of illicit money, it could be all kinds of things—but when the dollar is overvalued for reasons over which the workers have no control and the industry has no control, is it really fair for us to just sit there and let those industries be wiped out for that reason, when they are competitive, and, given a fair opportunity to compete, could do so?

Mr. BERGSTEN. I agree, Senator, that is a real problem. Indeed, a lot of the theoretical basis for open trade policy rests on some assumptions, one of which is currency balance, balance-of-payments equilibrium, and the like.

The problem you face, though, and I referred to it before in the context of flexible exchange rates, when you try to correct that through trade controls, I think you are basically shooting yourself in the foot. You are not really helping the country as a whole, and maybe even in some cases those workers.

I will give you a case in point: You remember, I know, the first voluntary restraint agreements on steel, which came in in the late

1960's and ran for about 5 years. It is my interpretation that those import controls on steel killed our steel industry; the reason is that in those 5 years, when they had protection from imports, the industry and union together worked out wage agreements that took the average steel wage in this country from 10 percent above the manufacturing average to 70 percent above the manufacturing average. They priced themselves out.

Now, that's not an inherent result of import control; but it sure happened that time, and it can happen very easily, unless you put in place some impediments to that and some corrective policies on the fundamentals at the same time.

So, I am enormously sympathetic for exactly the problem you raised. Go back to the early 1970's and the Burke-Hartke bill. I opposed that bill; I thought it would have been a terrible mistake. But I can understand and have some sympathy for the motivations that generated it, because that was the previous period of massive dollar overvaluation. When the dollar is overvalued, as I would submit by 25 percent, that is of course like putting a tax of 25 percent on everything we try to sell abroad and paying a subsidy of 25 percent on everything coming into the country. So it's an enormous problem in exactly the terms you put it.

But the bottom line has got to be: Deal with the fundamentals of the problem—the budget deficit, the interest rates, and that range of problems.

If you have to go to second best, it is simply ineffective to do it through trade measures, and you are likely to wind up shooting yourself in the foot as with that steel example. If you have to do something in terms of direct intervention, do it on the capital flows, because then you are supporting the correction of the exchange rate, and you are not causing the disruptions to the real economy that you are when you impede trade flows.

Senator LONG. I just wonder whether it is a disruption. Let me just state the case. Let's assume your dollar is 30 percent overvalued, and the result is that your industry is going to be liquidated by virtue of that fact alone. Let's assume that that's the straw that breaks the camel's back.

Now, if you wanted to, for lack of a better way, if you were going to do something like this—someone could show me a better way of doing it, I'm sure, but for lack of a better way—simply undertake to say, "Well, now, on a market-basket basis, look at what that yen would buy and what this dollar would buy. Their currency is 30 percent undervalued compared to ours. So we are going to have a 30-percent, or whatever it would take, tariff, just a flexible tariff to adjust the difference—I don't like that variable tariff they have in Europe, and I'm not sure I'd like this, but, you understand, for purposes of discussion—a variable tariff to adjust for the difference." You could tax away the difference, if you wanted to do so. That is purely a matter of Government decision, if you want to do it.

It seems to me that if you want to do it, you could say, "We will wipe out that advantage that occurred because of the difference in these exchange ratios."

Now, if this Government wanted to do it, why wouldn't that put us on a competitive equality with the other side?

Mr. BERGSTEN. Well, the problem is the one mentioned before, that whether you use a variable levy or a straight tariff increase or a surcharge, however you did it, you would tend to have this offsetting effect on the exchange rate, because as you reduced imports you would strengthen our trade balance, and that would push the dollar up further, and you would get more overvaluation.

Say you had a 30-percent overvaluation going in. You put on a 10-percent import surcharge. Theory would tell you the dollar would then rise to be 40 percent overvalued, and the whole thing would net out.

Therefore, I would say, if you felt you had an industry that you just had to save, at any cost—and it would be costly—you would have to go to some kind of quota protection or specific tariff protection for that industry, recognizing that there would be an offsetting effect that would hurt all your other industries. You would have to take that price.

I just don't see any way around that conundrum under flexible exchange rates.

Senator LONG. Do you have a comment, Mr. Wallich?

Governor WALLICH. I wanted to say exactly the same thing, Senator Long. If the dollar is 30 percent overvalued and we restrict imports to protect some industry, we drive up the exchange rate further, and the next industry comes in, and we do the same for them, and it goes to 50 percent; meanwhile, the first industry is not satisfied anymore. This is a game that really is not a winning game.

Senator LONG. I want to explore one other matter with you. It has to do with a concept that Pete Peterson stated when he was Secretary of Commerce up here, in charge of negotiating trade negotiation arrangements.

I heard him make the statement to the representatives of the foreign governments there at the time—I believe it was at the Blair House for a reception—that his thought was that if every nation would be willing to settle for a balance in their trade accounts, and I am not talking about individual nations but an overall balance in their accounts, that he thought if they would do that, that you ought to be able to solve the whole problem; because if every nation had a balance, the overall would have to work out to a balance.

What do you think about that concept, Mr. Bergsten? I guess you might have heard about it at one time or the other, or thought about that concept.

Mr. BERGSTEN. If you amend the trade balance to current account balance, I wouldn't have too much trouble with the concept, with one caveat. The reason I say current account rather than trade is that some countries do have structural surpluses or deficits on their services transactions. For example, our own country until recently—as we were discussing earlier—has tended to earn $30 to $35 billion a year on services transactions, mainly investment income.

So it seems to me that we could therefore afford to run a merchandise deficit of roughly that magnitude, come out with a balance in goods and services, and be in a roughly equitable as well as efficient position.

Germany and Japan have the opposite; they have structural deficits on services, so they need merchandise surpluses. So that's one caveat.

The other is to go back to capital flows. Traditionally the view has been, contrary to what is happening now, that the richest countries like our own, but the other industrial countries too, are net generators of savings which could be perhaps more profitably used in other parts of the world, like the developing countries, which are growing fast and have high rates of return.

Now, that's obviously been stood on its head in the last few years, with the United States becoming the most massive importer of capital the world has ever seen and indeed shifting to a debtor position. So I have to admit all that's a bit up in the air. And it's pretty hard to come up with a clean conceptual solution.

I guess if you would modify trade to current account and say everybody ought to shoot roughly for balance on that concept, I wouldn't have much trouble with it.

Senator LONG. Mr. Wallich.

Governor WALLICH. I would recommend looking at differences among countries even at the same income level. The United States, as we have heard several times today, is a very low-saving country, which is a deeply imbedded practice. The Japanese are very high-saving people, so in Japan savings are cheap. They can't use them all in their own country, and they tend to push them abroad. This depreciates the yen and gives them a trade surplus, which in effect achieves the real transfer of the capital exports. In that way they become a structural capital exporter.

Now, there isn't very much one can do about that, short of changing the nature of the country. Maybe in Japan, over the course of time, people will save less. Maybe in the United States people will save more; I hope so. But while these differences exist, we will probably have the differences in the structure of our surpluses and deficits that Fred Bergsten refers to.

Senator LONG. Mr. McNamar.

Secretary MCNAMAR. A couple of problems I would see with that, Senator. Obviously, some nations do have comparative advantages in one field or another. Argentina, for example, is able to grow agricultural products, beef and wheat, relatively less expensively than New Zealand is. New Zealand seems to do rather well at milk and cheese and dairy products. Would we then be suggesting that New Zealand should go into the wheat raising business in its rainy climate? And that Argentina should increase its dairy herds? I am not quite sure we want to take on the theory of comparative advantage that way.

I agree with what Governor Wallich said in terms of capital, for example, coming out of high-savings nations like Japan, but again, comparative advantage in capital is what you are looking at.

I have to now say that I have heard a lot of talk this morning, and I haven't jumped in too hard yet; but I really can't accept the premise that the U.S. dollar is necessarily overvalued by 30 percent or 25 percent. I wish I had that clairvoyance and analytical ability to make that kind of a calculation. But the more I look at it, the more I find that I don't think those numbers are very defensible.

At the same time, there has been a lot of talk this morning, and there has been a lot of talk for about the last 6 weeks, about the United States becoming a debtor nation. I suggested earlier that it might be well to wait a little while to look at the numbers, and see if what may be a blip is a secular trend or not.

For example, I think the genesis of this was a Wall Street Journal article about a BIS [Bank for International Settlement] report saying that during the third quarter of 1983 the United States had become, for the first time in recent memory, a net borrower. Well, I think that was probably true for that quarter for the commercial bank lendings that they were looking at at that point in time. That had to do with a couple of factors, not the least of which was that some Mexican and Brazilian loan agreements had not been redone and therefore disbursements didn't take place, and therefore when interest payments came in we looked as though we were a borrower. Those numbers may or may not continue for 2 or 3 years, but the numbers that we base this type of analysis on are very questionable, Senator.

I think that if we watch these numbers pretty closely for 6 to 9 months, maybe it will take 18, we will get a little bit better picture, because our indications are that an awful lot of the demand for U.S. securities and investments still relates to the safe-haven effect.

It is very clear that during the missile debate in the West German Parliament, money went into U.S. CD's and money went into U.S. Treasury bills. Now, whether that makes the dollar overvalued by 25 or 30 percent, by somebody's measure, fine. I guess I wish I had that certainty because I could certainly make better decisions for the administration if I had it. But I see the world in more gray and not very much black and white.

Senator LONG. Mr. Roach.

Mr. ROACH. Just one comment on your question about running a balanced trade policy on a country-by-country basis: I think that in the world we live in that would be an exercise in utter futility. What the theory of comparative advantage really tells us is that countries with similar resource endowments should, in theory, be in trade balance with one another.

Unfortunately, in the environment we live in, with innumerable trade restrictions on both sides of the waters, we are a long way from the free market system that needs to be in place to let the theory of comparative advantage even things out, even for countries with similar resource endowments.

So I do not think, that policy recommendations along those lines would be practical or wise.

Senator LONG. Let me just comment on one point that was made and several points that all of you made that deserve comment.

When you referred, Mr. Wallich, to the low savings in the United States, the low capital savings in the United States, I find myself thinking that that's one of the things that we could expand if we wanted to by policies up here.

For example, I don't know whether we could afford what we did with regard to the individual retirement accounts, but I know that it is costing the Treasury just a lot more money than the estimate—probably two or three times the estimate. That's because it

provided that tax incentive to save, and a tremendous number of people went into it. And there is a limit to how much you can put into an IRA.

Now, if we wanted to provide for small savers, for middle-income people, the same incentive that there is for upper income people—for an upper income person, you save 50 cents on the dollar by making an investment if you can deduct it all, as with an IRA. If we did that type of thing that would give the same tax advantage, which would require a 50-percent tax credit rather than across the board, there would be all kinds of little people who would come charging in to participate in it, who are not interested in it if when they put their money in the IRA they only save 20 percent because they are at that particular tax rate.

Secretary McNAMAR. I think that's right, Senator. We will be coming back, as you know, with a number of tax recommendations to the President, or available for the next President, at the end of this year. I think that Congress will want to look at those kinds of things.

Let me suggest—and here is a place where, not being an economist, I don't share the views of many economists. Marty Feldstein, for example, talked about a 2.9-percent savings rate. Well, there are different ways to measure that rate, but one of the things that is not noticed is what this committee has done, for example, with ACRS. And ACRS, in fact, if it increases an individual filer's cashflow, I submit has contributed to the national savings pool.

Senator LONG. Of course it has; that's a great big item.

Secretary McNAMAR. That's right. And that same thing is true in corporate America as well as for single filers, individual filers.

And if you look, for example, and Governor Wallich could talk as an expert to this, if you look at commercial industrial loan demand at our 50 largest banks, until very, very recently it has not picked up at all. It has had less than a 2-percent variance up and down from where it was 15 months ago. What does that tell you? It says we've gone through all this economic expansion in 1983 and into 1984, and corporations have not been in borrowing.

Well, what's happening? ACRS has improved their corporate cashflow from the new investments they have made. It has finally started to kick in. And yet, what happens to the national savings numbers? Do they show that? No.

Senator LONG. Why can't you find some way to make the figures show that? [Laughter.]

Secretary McNAMAR. I think that they ought to be added back in some way. I agree with you. That's not in my department, but I think you are absolutely right—it ought to be reflected.

Senator LONG. You know, that's one of the banes of my existence as a member of the Finance Committee, and I found it even more so when I was chairman of the committee. We come up with something that's a good idea, that works, and we have to take a beating on the budget as though this thing is bankrupting the country, when they won't give us the credit, the full credit, for the benefit.

If I might just mention something on a somewhat irrelevant subject, but it happened here just this morning while you were sitting there waiting for your turn to testify; we reported out this bill for child support. Now, that goes down on the ledger sheet as a big def-

icit item that is costing this Government money, to make fathers contribute to the support of their own children. We are going to put a lot of money into the hands of little children out there, with those mothers providing for the children better than they did before, by making a bunch of deadbeats come in and do their duty.

Now, there is no way that you could estimate how much we are going to save on those welfare rolls, because it becomes the thing to do, "If you don't pay up for the support of your children, somebody's going to come get you; the long arm of Uncle Sam is going to go after you." And we even will make the Internal Revenue Service go out and grab the fellow and squeeze something out of him.

Now, that makes the rule work the way it does for affluent people. Every man here knows that affluent people in the country pay child support, for the simple reason that if they don't, they are going to be sued and made to pay.

There is no way they can calculate how much money we save just by keeping people off the welfare rolls with that, by helping mothers who are not on welfare to stay off welfare. So we all know we have those hidden benefits and hidden costs.

Did you want to comment on that? Oh, you've got to go.

Secretary MCNAMAR. Thank you.

Governor WALLICH. I just wanted to say, Senator Long, that the good things that have been done in the way of increasing corporate cashflow do get into the data. They don't get into the savings data because those are net savings, after depreciation. And what has been done here, the accelerated cost recovery, means that depreciation allowances are larger.

So it is recognized in the data, even though not in the particular category of net savings.

Senator LONG. I want to thank you gentlemen for the time you have made yourselves available to answer the questions I have asked here.

This little box there with those three lights on it was my doing when I was chairman of the committee. I was trying to expedite the movement of bills, so I brought an egg timer in, and after a while we substituted these lights for the egg timer. But sometimes it serves a purpose for some of us to take enough time to explore the things that concern us.

You know, we didn't hear anybody come here as the economist for organized labor, to testify at this meeting, and I find myself thinking that, with all deference to those very fine people, the labor unions may be a bit limited in this context, because they don't have the same problems on a day-to-day basis as you gentlemen do. Sometimes, they are hard pressed to match the expertise that is provided in industry, in the way of economists.

But we need to make a record such as this one so that everybody out there, including some fellow who has never had any economics but has a lot of commonsense, can read it and can come to their own conclusions as to what they think is best for the country.

Thank you very much.

[Whereupon, at 1:27 p.m., the hearing was concluded.]

[The following communications were submitted and by order of the chairman are made a part of the hearing record:]

STATEMENT OF ALFRED ECKES, CHAIRMAN

UNITED STATES INTERNATIONAL TRADE COMMISSION

BEFORE THE COMMITTEE ON FINANCE, U.S. SENATE

MARCH 23, 1984

Mr. Chairman and members of the Committee, I am pleased to have the opportunity to submit this statement regarding the nation's rising trade deficit. As you know, one of the functions of the International Trade Commission is to monitor shifting trade patterns so that it can alert Congress and the Executive to factors that may affect future trade legislation and policy. In recent years, there have been many dramatic changes in trade patterns, both in the direction and composition of U.S. trade. This statement will focus on those changes, first offering a five-year perspective of U.S. trade in merchandise and services, and then an examination of developments in 1983.

Several themes emerge in this overview:

- the U.S. merchandise trade deficit has mushroomed in the past few years -- encompassing most trade sectors and trading partners -- even the European Community and China joined the list of countries with whom we ran a deficit in 1983;
- deficits with the newly industrialized countries (NIC's) have soared -- in 1983, the merchandise trade deficit with the NIC's accounted for more than one-third of the total merchandise deficit with all our trading partners;
- our merchandise trade deficit with the OPEC countries has declined sharply in the past two years, reflecting reduced petroleum imports from those countries;

- increasingly the U.S. is importing manufactured products while maintaining its only merchandise trade surpluses in two sectors supplying raw materials: agricultural, animal, and vegetable products, and chemical and related products; and
- our surplus in international business services trade, depended upon to offset merchandise trade deficits, is now shrinking as the U.S. increases imports of business services and encounters competition for services in overseas markets.

The U.S. has experienced a large and growing trade deficit during the past five years, which more than doubled from $23.3 billion in 1979 to $54.2 billion in 1983. 1/ The deterioration in the merchandise trade balance is striking, as that deficit ballooned from $27.3 billion in 1979 to $60.7 billion in 1983.

A surplus in international business services trade helped to offset the merchandise trade deficit in this period, but that surplus decreased in the past two years. The business services surplus climbed from $4 billion in 1979 to $9 billion in 1981, and then fell to $6.5 billion in 1983.

Further examination of the five-year history of U.S. merchandise trade reveals major changes in both trading sectors and trading partners. On the basis of sector, the largest shift occurred in machinery and equipment, where a $16.6 billion positive trade balance in 1979 eroded to a $2.6 billion

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1/ For the aggregate data quoted here, import values are based on the Customs value of imports for consumption; export values are based on f.a.s. value at U.S. port of export. These data include imports from TSUS schedule 8 and other special provisions, which cannot be assigned to trade sectors and therefore are omitted from the trade tables and the country and sector data provided later in this statement.

deficit in 1983. The U.S. exported 17 percent more machinery and equipment (by value) in 1983 than it did in 1979, but the growth in imports in this sector was a much more impressive 58.5 percent.

The positive trade balance in these articles peaked in 1981 at $27.0 billion and then deteriorated rapidly. The decrease in U.S. exports since the 1981 peak is related to a number of factors, including a prolonged recession. Oil-producing countries reduced or slowed their industrial development as a worldwide oil glut reduced their revenues. Sector exports to OPEC countries alone decreased by 34 percent since the 1981 peak. The rise in imports in this sector reflected increases in imports of office machines, automobiles, radio-telephonic and telegraphic apparatus, and semiconductors, much of this trade from the Far East.

The trade deficit in the minerals and metals sector also showed a substantial 107 percent growth in the 1979 - 1983 period. Iron and steel mill products accounted for more than one-third of the sector deficit in 1983, although import trade in these products actually declined 10 percent between 1979 and 1983. Precious metals and cut diamonds showed the largest increases in import trade, reflecting speculative trade in silver and a growing demand for diamonds. Exports in the sector declined 30 percent in the five-year period. Nearly two-thirds of this decrease was in precious metals, as sales of gold bullion moderated.

Another sector exhibiting a significant increase in trade deficits during this period was textiles, apparel, and footwear. The 200 percent deficit increase from 1979 to 1983 showed the vulnerability of the U.S. apparel market to penetration by low-cost imports from Asia. Hong Kong, Korea, and Taiwan traditionally have been suppliers, and recently their shipments have been augmented by new suppliers such as China, Thailand, Sri Lanka and Indonesia.

There was a smaller shift of over $1.6 billion from a positive to a negative trade balance for the miscellaneous manufactures sector. This was largely due to a nearly 50 percent rise in imports, while exports remained relatively flat. Much of the increase in imports was in labor-intensive products (especially from the Far East) such as handbags, luggage, games, furniture and toys. Furniture, for example, experienced an 81 percent increase in imports from 1979 to 1983, as Far Eastern countries (notably Taiwan) mastered finishing techniques and attained a quality level satisfactory to the U.S. consumer at a lower price.

One sector where the trade deficit declined (12 percent) in the five years since 1979 was energy and chemicals. U.S. imports of these products increased 2 percent to $72 billion in 1983, but exports increased 26 percent to $32 billion during the same period. Helping to keep the overall import level increase down was a 9 percent decrease in the trade deficit for crude petroleum, natural gas and related products. There was a positive trade balance for chemicals, coal and related products during the five-year period, which increased very slightly to $11.9 billion in 1983.

The continuing bright spot in the merchandise trade picture has been agriculture, animal, and vegetable products, although this light dimmed somewhat in the last two years. The trade balance for this sector rose from $15.4 billion in 1979 to $23.4 billion in 1981, and then fell to $16.0 billion in 1983.

This pattern can be attributed primarily to fluctuations in agricultural exports, which increased from $34.8 billion in 1979 to $43.7 billion in 1981, but then declined to $36.5 billion by 1983. Grain exports were primarily responsible for these changes, the decline in the last two years reflecting the recession and large harvests by most wheat-producing countries.

The trade balance in forest products varied during 1979-1983, rising from a negative $1.9 billion in 1979 to a negative $2.4 billion in 1983. These fluctuations, including a recent increase in imports, can be attributed to changing levels of domestic housing starts.

When we turn from the elements of U.S. merchandise trade to our partners in this trade, there have been several significant changes. Trade deficits with Canada and Japan have continued and substantially deepened in the 1979-1983 period. The deficit with Canada was $5.6 billior in 1979 and $14.3 billion in 1983, accounting for over one-fourth of the total merchandise trade deficit with all trading partners last year. The largest deficit in 1983 was in the mineral fuels sector, due to U.S. imports of petroleum and natural gas. Imports of forest products also contributed substantially to the deficit. Strong demand for automobiles in the U.S. led to an increase in imports of motor vehicles and parts in 1983.

The deficit with Japan in merchandise trade grew from $9.1 billion in 1979 to $19.4 billion in 1983. Large deficits were found in machinery and transportation (particularly automobiles and lightweight trucks) and manufactured goods such as consumer electronics and office machines.

A surplus of $8.2 billion in merchandise trade with the European Community in 1979 fell to a deficit of $0.3 billion in 1983. Imports from the region have increased steadily since 1979, while U.S. exports to the region declined rapidly after 1980. Major imports from the EC were machinery and equipment, minerals and metals, and petroleum, natural gas and related products. The major U.S. exports to the region were machinery and equipment, agricultural products, and chemicals.

The large merchandise trade deficit of $27.6 billion the U.S. experienced with the OPEC countries in 1979 shrank to $9.7 billion in 1983. Petroleum and petroleum products still constituted 88 percent of U.S. imports from the OPEC countries in 1983, although imports in this sector declined by 23 percent from 1982 levels, following a 38 percent drop from 1981 to 1982.

One dramatic trade shift that occurred in the 1979-1983 period was the increase in our merchandise trade deficit with the NIC's, including Mexico, Brazil, Argentina, Hong Kong, Taiwan, Korea, and Singapore. The deficit of $2.0 billion in 1979 swelled to $22.0 billion in 1983, reflecting increased imports of everything from textiles, apparel and footwear, to miscellaneous manufactures. More will be discussed concerning the NIC's when we turn to examine the 1983 data.

The services accounts in the U.S. balance of payments have shown a surplus in all recent years. Included in the services accounts are some items that are not really trade related such as income on direct and portfolio investment. However, if we consider the data for international business services -- including such items as travel and transportation, reinsurance, and construction and engineering -- the U.S. had a $4 billion surplus in 1979, in contrast to a $6.5 billion surplus in 1983. Services exports reached a new high of $42.3 billion in 1983, over 38 percent greater than the $30.6 billion registered in 1979. Services imports also reached a new high in 1983, however, contributing to a shrinking services surplus for the second year in a row (the services surplus peaked at $9 billion in 1981).

This development must be closely monitored because consistent U.S. surpluses in services have helped offset the deficits in the merchandise account that have occurred in 11 of the past 24 years. In addition, our

services activities overseas also make a significant positive contribution to merchandise trade. A recent Commission study indicated that at least $48 billion, or about 23 percent of total U.S. merchandise exports in 1982, were generated as a direct result of demand from U.S. service operations abroad. 2/ Examples include computers, machinery and equipment, processed food, and hospital equipment and supplies. It appears that competition from foreign service companies is growing in traditional U.S. markets -- ranging from exports of software by Brazil and India and health services by German and Swedish companies, to exports of financial information services by Japan and the United Kingdom and construction services by Asian countries.

While the services surplus narrowed in 1983, the merchandise trade deficit grew another $25.5 billion. There were trade balance declines in every major merchandise trade sector with the exception of petroleum, natural gas, and related products. The most significant shift occurred in the machinery and equipment sector, where the trade balance dropped from a surplus of $14.9 billion to a deficit of $2.7 billion. This decline reflected cutbacks by developing nations which normally account for a large portion of U.S. exports of these capital goods, as well as increased competition from other industrial nations seeking export markets. It also demonstrated the continued U.S. demand for Japanese automobiles and strong growth in imports of office machines, semiconductors, and telephonic or telegraphic apparatus. The U.S. maintained a trade surplus in only two sectors in 1983: agricultural, animal, and vegetable products; and chemicals and related products.

2/ The Relationship of Exports in Selected U.S. Service Industries to U.S. Merchandise Exports, Investigation No. 332-132, USITC Pub. 1290 (September 1982).

Overall, U.S. merchandise trade exports declined 5.4 percent from the 1982 level to $196.0 billion. U.S. imports, on the other hand, increased 5.9 percent in 1983 to a total of $256.7 billion. 3/ Exports declined in all sectors in 1983, while imports rose in all sectors but petroleum, natural gas, and related products.

In addition to the negative shift in the machinery and equipment sector, changes in certain other sectors in 1983 should be noted. In the textiles, apparel and footwear sector, U.S. exports of fibers and textile mill products dropped 12 percent from 1982 levels to $4.9 billion. Approximately 60 percent of this decrease was a result of lower shipments of raw and processed fibers to China. At the same time, apparel increased about 17 percent in 1983 to $9.6 billion. Most of the increased imports continued to come from Hong Kong, Taiwan, the Republic of Korea, and China. U.S. imports of nonrubber footwear increased by $578 million to a record level of nearly $3.7 billion.

In the minerals and metals sector, U.S. exports of iron and steel mill products decreased by $561 million in 1983 to a level of $1 billion. Imports of these products also decreased by $2.6 billion, but the resulting 1983 level was still a comparatively high $6.4 billion. The decrease in the import figure reflects a drop in the unit value of all major product categories and a sharp decline in the volume of higher-value pipe and tube imports.

Finally, in the chemical and energy sectors, U.S. imports of crude petroleum decreased 22 percent to $36 billion in 1983 as a direct result of lower import values. Imports of petroleum products increased by 15 percent to $15 billion, primarily as a result of excess offshore production entering the

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3/ See footnote 1, page 2.

U.S. market. U.S. exports of petroleum products, however, fell by 21 percent in 1983 to $3.8 billion, again reflecting oversupply on the world markets. Exports of coal decreased 30 percent to $4.5 billion as a result of lower world steel production, an abundance of petroleum, and increased competition from other coal-producing nations.

Merchandise trade balances with our trading partners generally worsened during 1983, with the exception of the OPEC countries. The OPEC deficit decreased 10 percent in 1983, following a 62 percent drop in 1982. This decrease reflected declining dependence on OPEC oil and lower oil prices. However, the surpluses the U.S. had maintained with OPEC in certain other sectors, such as machinery and equipment, declined as a result of reduced OPEC purchasing power.

The U.S. merchandise trade deficit with Canada increased by 12 percent in 1983. Two-thirds of the increase occurred in the forest products area as a rise in U.S. housing starts encouraged lumber imports.

With Japan, the U.S. trade deficit increased 16 percent in 1983. The trade imbalance was due primarily to trade in manufactured goods. Imports of machinery and equipment (including motor vehicles, office machines and consumer electronic products) were $25.0 billion higher than in 1982.

Merchandise trade with the EC fell into the deficit category ($0.3 billion) in 1983 from a $4.5 billion surplus in 1982. Imports from the region rose by 4 percent as U.S. exports dropped by 7 percent. Contributing to the export decrease, exports of agricultural products declined $1.1 billion to $7.5 billion, as EC surpluses of wheat and skim milk powder were used for animal feeds, limiting purchases of soybean products and corn. Coal exports declined by $1.0 billion -- the major component of the decline in chemical and energy exports. Lower steel production in the EC and increased competition from Poland accounted for lower coal sales.

The newly industrialized nations pose a significant trade challenge to the U.S. based on the merchandise trade data for 1983. For example, the trade deficit with Brazil more than doubled to $2.4 billion, as exports to Brazil declined 25 percent and imports from that country increased 18 percent. Contributing to the export decline, machinery and equipment exports to Brazil dropped 34 percent and chemicals and related products, 17 percent. On the import side of the ledger, the U.S. increased its imports of automotive parts, iron and steel, petroleum products, and nonrubber footwear. As one of the NIC's with a heavy international debt burden, Brazil has sought to cut back imports while pushing exports to raise foreign exchange for debt service.

The merchandise trade deficit with Hong Kong rose 24 percent in 1983 to $3.9 billion. Textiles and apparel accounted for 60 percent of that deficit, and machinery and equipment accounted for 31 percent. U.S. imports of office machinery parts, telephonic apparatus, generators, and radio equipment added to the machinery and equipment deficit with Hong Kong.

The U.S. trade deficit with the Republic of Korea in 1983 reached $1.5 billion, a 400 percent increase over 1982. U.S. exports to Korea were slightly above 1982 levels, but imports from Korea rose almost 27 percent. The largest deficits were in textiles, apparel, and footwear. The most significant trade shift, however, was in machinery and equipment, where the U.S. experienced a $135.7 million deficit in 1983, compared to a $519 million surplus in 1982. Increasingly, the U.S. is importing from Korea such articles as color telephones, microwave ovens, personal computers and other consumer items that fall in this sector.

Another Far Eastern NIC with whom the U.S. had a rapidly increasing merchandise trade deficit in 1983 was Taiwan. There the deficit was $6.8 billion, 45 percent higher than in 1982. Again, 1983 exports to Taiwan

were slightly higher than in 1982, but imports from Taiwan were 26 percent higher than they were that year. The greatest sector deficit was in miscellaneous manufactures due to high U.S. imports of luggage, furniture, and game machines. Taiwan also was the second highest supplier of imported textiles and apparel to the U.S. in 1983, and the trade deficit in that sector was $1.9 billion. The most significant trade shift with Taiwan occurred in the machinery and equipment sector where imports of telephone apparatus and parts helped to push the trade deficit up 128 percent to $2.1 billion.

The NIC bordering our country, Mexico, also increased its trade imbalance with the U.S. in 1983. Imports from Mexico increased 8 percent while exports to that country decreased 21 percent. The U.S. merchandise trade deficit with Mexico climbed 81 percent in 1983 to $7.6 billion. Major deficits were found in the petroleum and the minerals and metals sectors.

A group of trading partners with which the U.S. had a trade surplus in 1983 were the nonmarket economy countries (NME's), but that surplus declined over 56 percent from the 1982 level. The decrease was due largely to a sharp decline in U.S. exports to these countries, especially China (China accounted for 62 percent of U.S. imports from NME's and 43 percent of U.S. exports to these countries in 1983). U.S. exports to China--particularly raw cotton and agricultural products--were down 25 percent to $2.2 billion in 1983, while imports remained almost unchanged from 1982. As a result, the trade balance with China dropped from a surplus of $708 million to a deficit of $23 million during the year.

This concludes my overview of the data on U.S. trade deficits in the 1979 to 1983 period. It has been descriptive rather than prescriptive, because although Commission research may point to some of the factors that contribute to the discouraging trade picture we see today -- e.g. the high value of the dollar, slow economic recovery in major foreign markets, and increasing

competition from low-wage, emerging industrial countries -- we do not attempt to pose solutions. I do add my personal caution, however, that policy makers not oversimplify the problem as one that will vanish should the value of the dollar decline and unfair trade practices cease. The U.S. must recognize the extent of the competitive challenge it faces today in the world marketplace and its industries must be encouraged to move quickly to meet that challenge.

APPENDIX

A-1

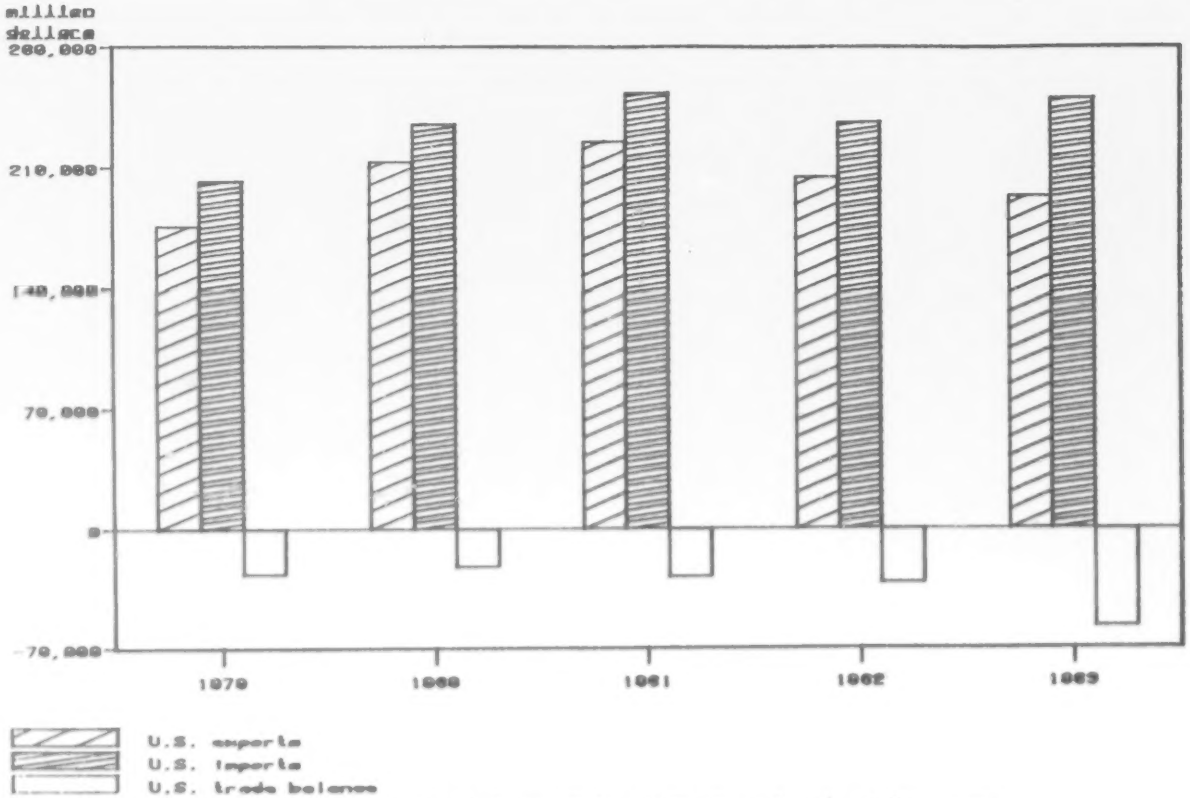
Table 1.—U.S. exports of domestic merchandise, imports for consumption, and merchandise trade balance, by major commodity sectors, 1979 and 1983 1/

(In thousands of dollars)

Item	1979	1983
U.S. exports of domestic merchandise:		
Agricultural, animal, and vegetable products	34,835,326	36,523,114
Forest products	7,806,450	8,358,366
Textiles and apparel	7,072,309	5,752,844
Footwear	83,091	102,213
Petroleum, natural gas, and related products	1,431,728	4,547,988
Chemicals and related products	23,591,076	27,067,453
Minerals and metals	19,530,102	13,682,418
Machinery and equipment	70,260,124	82,353,638
Miscellaneous manufactures	11,459,776	15,003,014
Total	176,069,984	193,391,052
U.S. imports for consumption:		
Agricultural, animal, and vegetable products	19,399,190	20,544,529
Forest products	9,698,607	10,808,405
Textiles and apparel	8,023,528	13,272,051
Footwear	2,908,580	4,007,341
Petroleum, natural gas, and related products	59,273,636	57,005,718
Chemicals and related products	11,765,641	15,138,370
Minerals and metals	27,155,538	29,332,725
Machinery and equipment	53,629,969	85,009,192
Miscellaneous manufactures	10,568,989	15,744,101
Total	202,423,681	250,862,436
U.S. merchandise trade balance:		
Agricultural, animal, and vegetable products	15,436,136	15,978,585
Forest products	-1,892,157	-2,450,039
Textiles and apparel	-951,219	-7,519,207
Footwear	-2,825,489	-3,905,128
Petroleum, natural gas, and related products	-57,841,907	-52,457,730
Chemicals and related products	11,825,434	11,929,082
Minerals and metals	-7,625,435	-15,650,306
Machinery and equipment	16,630,154	-2,655,554
Miscellaneous manufactures	890,786	-741,086
Total	-26,353,696	-57,471,384

1/ The trade data provided in this table are based on trade in schedules 1 through 7 of the Tariff Schedules of the United States (imports) and Schedule B (exports); trade under schedule 8 and other special provisions is not included. In 1983, imports in the excluded provisions amounted to $5.8 billion and exports amounted to $2.6 billion. Import values used in the report are based on customs value; export values are based on f.a.s. value, U.S. port of export.

Chart 1.--U.S. exports of domestic merchandise, imports for consumption, and merchandise trade balance, by years, 1979 thru 1983



Source: Compiled from official statistics of the U.S. Department of Commerce.

U.S. Merchandise Trade Balance, 1979-1983

(Million dollars)

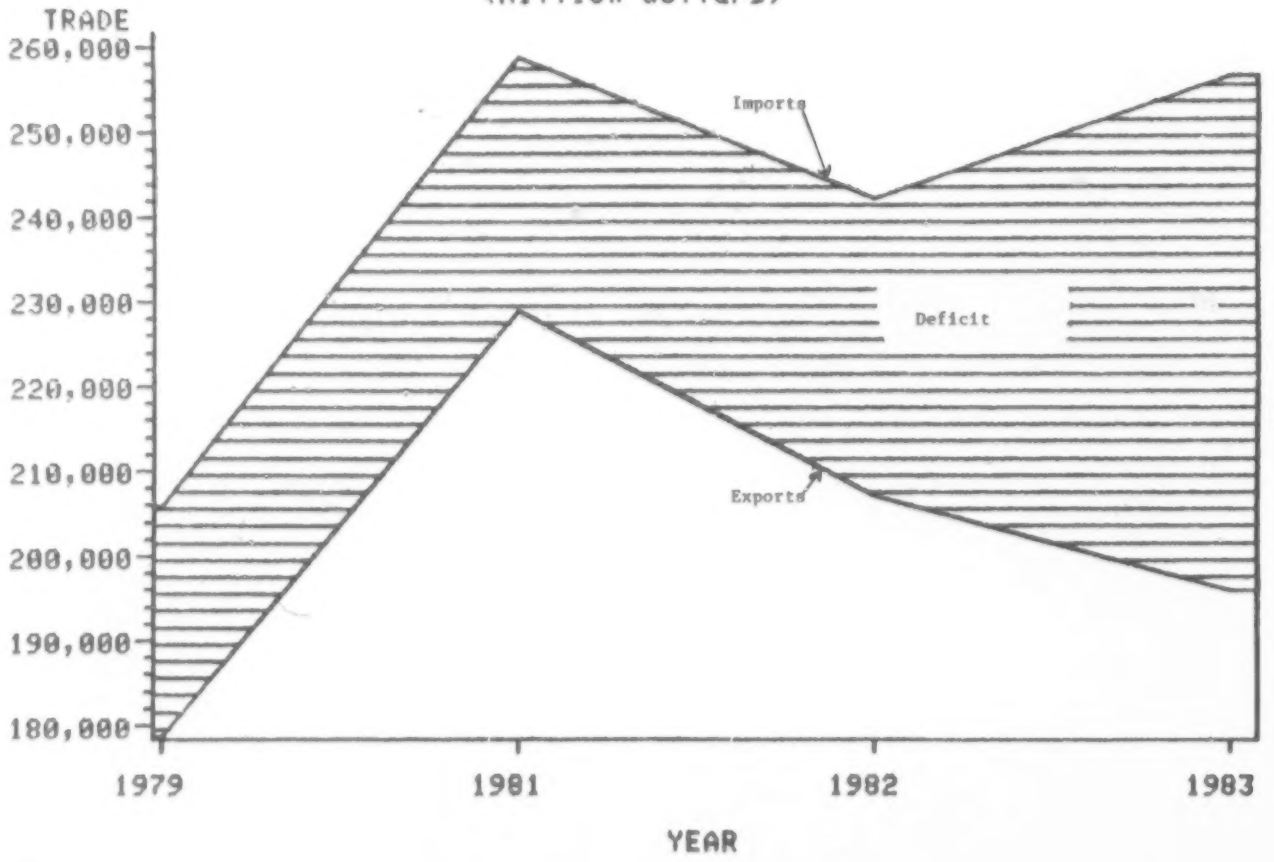


Table 1.--U.S. exports of domestic merchandise, imports for consumption, and merchandise trade balance, by major commodity sectors, 1981, 1982, and 1983 1/

(In thousands of dollars)

Item 2/	1981	1982	1983
U.S. exports of domestic merchandise:			
Agricultural, animal, and vegetable products	43,679,477	37,141,668	36,523,114
Forest products	9,217,577	8,482,079	8,358,366
Textiles and apparel	8,207,461	6,519,283	5,752,844
Footwear	140,564	119,579	102,213
Petroleum, natural gas, and related products	3,193,054	5,716,850	4,547,988
Chemicals and related products	30,749,127	29,173,819	27,067,453
Minerals and metals	19,953,230	14,759,960	13,682,418
Machinery and equipment	95,536,029	87,291,151	82,353,438
Miscellaneous manufactures	14,893,751	15,290,409	15,003,014
Total	225,570,275	204,494,803	193,391,052
U.S. imports for consumption:			
Agricultural, animal, and vegetable products	20,260,723	19,037,957	20,544,529
Forest products	9,647,202	9,020,612	10,808,405
Textiles and apparel	10,843,122	11,270,161	13,272,051
Footwear	3,141,218	3,433,638	4,007,341
Petroleum, natural gas, and related products	80,337,109	64,721,415	57,005,718
Chemicals and related products	13,506,035	13,340,607	15,138,370
Minerals and metals	34,386,404	29,246,777	29,332,725
Machinery and equipment	68,542,029	72,360,071	85,009,192
Miscellaneous manufactures	13,297,782	14,132,986	15,744,101
Total	253,961,628	236,564,228	250,862,436
U.S. merchandise trade balance:			
Agricultural, animal, and vegetable products	23,418,753	18,103,711	15,978,585
Forest products	-429,624	-538,532	-2,450,039
Textiles and apparel	-2,635,660	-4,750,878	-7,519,207
Footwear	-3,000,654	-3,314,058	-3,905,128
Petroleum, natural gas, and related products	-77,144,054	-59,004,564	-52,457,730
Chemicals and related products	17,243,092	15,833,212	11,929,082
Minerals and metals	-14,433,174	-14,486,816	-15,650,306
Machinery and equipment	26,993,999	14,931,079	-2,655,554
Miscellaneous manufactures	1,595,969	1,157,423	-741,086
Total	-28,391,353	-32,069,425	-57,471,384

1/ The trade data provided here are based on trade in schedules 1 through 7 of the Tariff Schedules of the United States (imports) and Schedule B (exports); trade under schedule 8 and other special provisions is not included. In 1983, imports in the excluded provisions amounted to $5.0 billion and exports amounted to $2.6 billion. Import values used in the report are based on customs value; export values are based on f.a.s. value, U.S. port of export.

2/ The product coverage of each of the sectors presented is identified (in terms of the Tariff Schedules of the United States) later in this report on the first page of the textual analysis for each sector.

Table 2.--All merchandise sectors: U.S. exports of domestic merchandise, imports for consumption, and merchandise trade balance, by selected countries and country groups, 1981, 1982, and 1983 1/

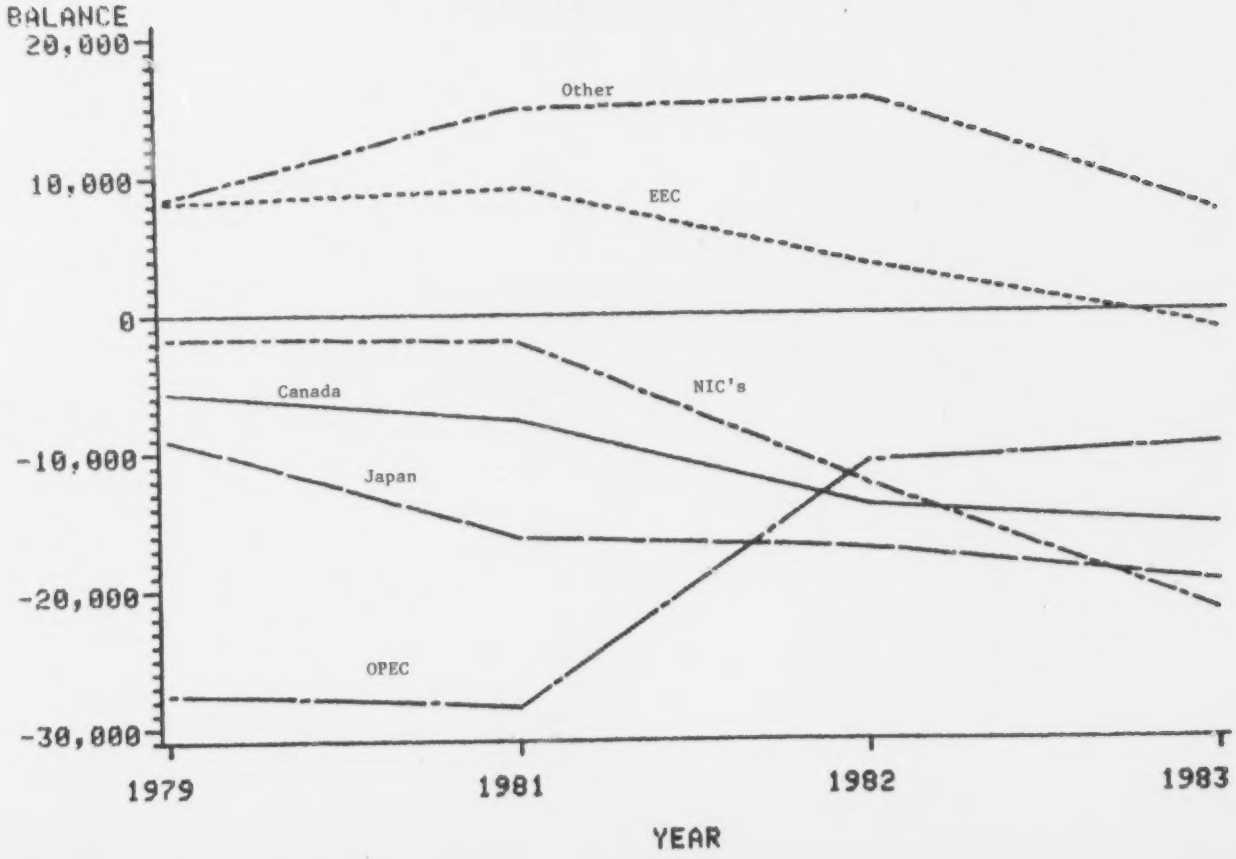
(In thousands of dollars)

Item	1981	1982	1983
U.S. exports of domestic merchandise:			
Canada	37,037,449	31,564,006	35,651,224
Japan	21,250,771	20,295,017	21,163,064
EC	50,192,409	45,371,243	42,087,643
Brazil	3,718,189	3,352,603	2,503,624
Hong Kong	2,477,508	2,273,338	2,390,282
India	1,705,591	1,555,184	1,778,883
Korea	4,978,384	5,308,687	5,670,783
Mexico	16,982,986	10,858,344	8,641,304
Taiwan	4,121,402	4,073,154	4,275,828
OPEC	20,518,322	20,206,134	15,019,233
NMES	7,835,896	6,448,690	4,982,538
China	3,596,687	2,902,418	2,159,327
All other	54,751,363	53,188,397	49,226,440
Total	225,570,275	204,496,803	193,391,052
U.S. imports for consumption:			
Canada	44,091,765	44,411,018	49,910,674
Japan	37,216,679	37,045,610	40,572,026
EC	40,131,743	40,835,804	42,389,298
Brazil	4,284,307	4,113,756	4,862,503
Hong Kong	5,191,799	5,392,568	6,262,346
India	1,194,440	1,390,406	2,175,026
Korea	5,133,514	5,600,736	7,132,278
Mexico	13,260,717	15,037,527	16,205,830
Taiwan	8,001,601	8,797,619	11,081,359
OPEC	48,985,497	30,917,991	24,662,743
NMES	3,371,238	3,249,167	3,537,076
China	1,824,190	2,194,707	2,181,850
All other	43,098,323	39,772,071	42,071,270
Total	253,961,628	236,564,228	250,862,436
U.S. merchandise trade balance:			
Canada	-7,054,316	-12,847,011	-14,259,450
Japan	-15,965,908	-16,750,593	-19,408,961
EC	10,060,665	4,535,438	-301,655
Brazil	-566,118	-761,152	-2,356,878
Hong Kong	-2,714,290	-3,119,229	-3,872,063
India	511,151	164,777	-396,142
Korea	-155,130	-292,049	-1,461,494
Mexico	3,722,269	-4,179,182	-7,564,525
Taiwan	-3,880,198	-4,724,464	-6,805,530
OPEC	-28,467,174	-10,711,857	-9,643,510
NMES	4,464,658	3,199,523	1,445,461
China	1,772,496	707,711	-22,523
All other	11,652,039	13,416,326	7,155,169
Total	-28,391,353	-32,069,425	-57,471,384

1/ The trade data provided here are based on trade in schedules 1 through 7 of the Tariff Schedules of the United States (imports) and Schedule E (exports); trade under schedule 8 and other special provisions is not included. In 1983, imports in the excluded provisions amounted to $5.8 billion and exports amounted to $2.6 billion. Import values used in the report are based on customs value; export values are based on f.a.s. value, U.S. port of export.

U.S. Merchandise Trade Balance by Partners, 1979-83

(Million dollars)



CWT
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Statement for the Record to the Senate Finance Committee

March 23, 1984

Hearing on
The U.S. Trade Deficit

Consumers for World Trade (CWT) is a national, nonprofit, membership organization, established in 1978. CWT supports expanded foreign trade to help promote healthy economic growth; provide choices in the marketplace for consumers; and counteract inflationary price increases. CWT believes in the importance of increasing productivity through the efficient utilization of human and capital resources. CWT conducts its educational programs to keep American consumers informed of their stake in international trade policy and speaks out for the interests of consumers when trade policy is being formulated.

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On the basis of the January-February figures, the nation's deficit on merchandise trade account in 1984 would exceed $100 billion. Even if, as is likely, the deficit figure will be lower in later months, it is all but certain that the deficit for the year will be well above last year's $60 billion.

These foreign trade deficits tell us that many exporting and import-competing industries in the United States have been encountering difficult competitive problems which they attribute, to some extent correctly, to forces outside their control. It does not follow, however, that the trade deficit has impeded the economic recovery or worsened net unemployment, or that the nation is less well off because of it. On the other hand, protectionist measures to attack the deficit will be seriously damaging, to ourselves and to the rest of the world.

The prime causes of the trade deficit are the dollar's rise in value since late 1980, the cyclical disjunction in 1983 between the United States and Western Europe and Japan, and the semi-collapse of some big Latin American markets for U.S. exports. None of these should be expected to be permanent phenomena. As in other aspects of economic affairs, corrective forces will come into play. In fact, the dollar has depreciated by about 5 percent since the beginning of the year. Japan's economy is moving strongly upward and Western Europe shows signs of renewed growth. Mexico, our largest Latin American trading partner, appears to have begun a recovery. Our economic growth, moreover, will slow from the exceptionally rapid pace of recent quarters.

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Meanwhile, the trade deficit -- the surplus of imports -- has been having the positive effect of helping to keep inflation in check during a period in which demand for goods has been rising strongly in the United States. Looked at another way, the deficit represents a net inflow of savings from abroad. This inflow has come at a time when federal government and private sector claims on domestic savings have been very large. Without access to these foreign savings, interest rates would have had to have risen more, making the recovery considerably less buoyant than it was.

In short, it is wrong to believe that we could solve our real economic problems by trying to choke off imports. Rather, we would make them worse and American consumers would be the ultimate victims of such misguided policy.

Specifically, to invoke the surcharge authority of the 1974 Trade Act would be a giant mistake. In the first place, the surcharge might easily lead to a parallel appreciation of the dollar, in which case we would have done little or nothing for the deficit, but would have put in doubt everywhere the value of the American commitments to support an open world economy. If, however, the surcharge were actually to bite, consumers could count on paying higher prices, not only for imports, but for domestically produced goods as well. To give inflation a gratuitous boost at this point would hardly qualify as a statesmanlike act. Retaliatory or imitative actions by our trading partners are likely also. These would compound our mistake and more, for we could easily be in danger of undoing what remains of the progress made since World War II toward a sensible trading order.

To sum up: The trade deficit has its sources, not in other countries' malfeasance or even in a lack of American competitiveness, but rather in conditions that to an important degree will be self-correcting. As long as the merchandise deficit continues to outrun our earnings from the sale or lease of services abroad, however, we will benefit from a better inflationary record and from the foreign savings that will help to sustain investment needed for our economic future. To adopt protectionist measures to cope with the deficit will be either self-defeating or a gift to inflation and to higher interest rates, which will harm Americans and everyone else.

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